Supreme Court, U.S.
FILED
FEB 21 1992

No. 91-368

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

CHARLES H. FALK and JOAN FALK and
HILARY P. GARDNER and JUDITH C. GARDNER,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

ELIAS ROSENZWEIG*
STANLEY KLEIN
MICHAEL WEITZNER
BRAUNER, BARON, ROSENZWEIG & KLEIN
Attorneys for Petitioners
61 Broadway
New York, New York 10006
(212) 797-9100

* *Counsel of Record*

QUESTIONS PRESENTED

Whether the United States Tax Court has jurisdiction to apply the doctrine of equitable recoupment in redetermining a tax deficiency in the same manner as the District Courts and the Court of Claims. This Court reserved decision on this issue in the case of United States v. Dalm, ___ U.S. ___, 110 S. Ct. 1361, at 1370 n. 8 (1990), in which the issue was whether an allegation of equitable recoupment is sufficient to form an independent basis of jurisdiction.

In the alternative, whether the Tax Court may apply the doctrine of equitable estoppel to prevent the Commissioner of Internal Revenue from exacting an unconscionable double tax.

PARTIES IN THE COURT OF APPEALS

Petitioners Charles H. Falk, Joan A. Falk, Hilary P. Gardner and Judith C. Gardner respectfully pray that a writ of certiorari be issued to review the decision of the United States Court of Appeals for the Second Circuit entered in this proceeding on January 22, 1992.

Respondent is the Commissioner of Internal Revenue.

TABLE OF CONTENTS

Questions Presented. i

Parties to the Proceeding. ii

Table of Authorities iv

Citation of Opinion Below. 1

Jurisdiction 3

Constitutional and Statutory Provisions Invoked 4

Statement of the Case. 6

Reasons for Granting the Writ. . . . 13

A. Equitable Recoupment. 13
B. Equitable Estoppel. 57

Conclusion 64

Appendix A1

TABLE OF AUTHORITIES

Cases:

Bull v. United States, 295 U.S. 247 (1935) 27, 33, 50

Calumet Industries, Inc. v. Commissioner, 95 T.C. 257 (1990) . . 46

Commissioner v. Gooch Milling & Elevator Co., 320 U.S. 418 (1943) 18, 41, 42, 48

Commissioner v. McCoy, 484 U.S. 3 (1987) 23

Cook v. Commissioner, 90 T.C. 975 (1988) 49, 53

Crane v. Commissioner, 331 U.S. 1, note 37 (1946). 17

Estate of Schneider v. Commissioner, 93 T.C. 568 (1989) 26, 27

Estate of Smith v.Commissioner, 94 T.C. 872 (1990) 59

Flora v. United States, 362 U.S.145 (1960), *decision on rehearing of* 357 U.S. 63 (1960) 39

Fox et. al. v. Commissioner, T.C. Memo 1988-50 . . . . . 1, 2, 8

Gardner v. Commissioner, 2nd Cir., Docket No. 90-9140(L), Jan. 22, 1992. . . . . 2, 8, 11

Glass v. Commissioner, 87 T.C. 1087 (1986). 49, 53, 54, 57, 58, 59

Herrington v. Commissioner, 854 F.2d 755 (5th Cir. 1988) 57, 58, 59

Hill v. Commissioner, 95 T.C. 437 (1990) 47

Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983) . . 37

Kazi, et. al. v. Commissioner, T.C. Memo 1991-37 . . . . . 2, 11, 18

Kielmar v. Commissioner, 884 F.2d 959 (7th Cir. 1989) 57

Knapp v. Commissioner, 90 T.C. 430, (1988) 19, 20, 21

Lerman v Commissioner, 939 F.2d 44 (1991), cert. denied, Docket No. 91-628, December 2, 1991 . . . . . 1, 2, 8

Lewis v. Reynolds, 284 U.S. 281 (1932) 40

Lone Manor Farms, Inc. v. Commissioner, 61 T.C. 436 (1974) . . 44

Massey v.Commissioner, 3rd Cir. Docket No. 91-1360, Nov. 22, 1991 1, 11

Phillips Petroleum Co. v. Commissioner, 92 T.C. 885 (1989) 18, 20, 26

Phillips v. Commisioner, 283 U.S. 589 (1931) 40

Reynolds v. Commissioner, 861 F. 2d 469 (6th Cir. 1988) 24, 36

Rothensies v. Electric Battery Co., 329 U.S. 296 (1946) 42

Tufts v. Commissioner, 431 U.S. 300 (1983) 17

United States v. Bowcut, 287 F.2d 654 (9th Cir. 1961) 51

United States v. Dalm, ___ U.S. ___, 110 S. Ct. 1361 (1990) . . . . . passim

United States v. Sherwood, 312 U.S. 584 (1941) 40

Woods v. Commissioner, 92 T.C. 776 (1989) . 18, 19, 21, 23, 31, 36, 37, 60

Statutes:

Internal Revenue Code of 1986,
Title 26 U.S.C.
§1092. . . . . 7, 53
§1202. 55
§1256. 7
§6214. . . . . passim
§6511. 9
§6512. 9
§6532. . . . . 9, 39
§7422. 39
§7429. 30
§7442 . . . . . 4, 5
§7476. 30
§7478. 30
§7481. 30,43
§7482. . . . . .3, 8

28 U.S.C. §1254(1) 3

28 U.S.C. §2402 39

§108 of the Tax Reform Act of 1984, PL 98-368, §108, as amended. 7, 53

Section 274(g) of the Revenue Act of 1926, 44 Stat. 2 41

Miscellaneous:

Article I of the Constitution . 30

Seventh Amendment 40

Tax Reform Act of 1969, PL 91-172. 30

Fringe Benefit Moratorium, Section 1, Pub. L. 99-427, 92 Stat. 996 (1978). 21

Revenue Act of 1978, P.L. 95-600. 30

Title V of the Economic Recovery Tax Act of 1981, P.L. 97-34, §§501 et seq. 6, 7

Tax Reform Act of 1986, PL 99-514, §1808(d) 8

Technical and Miscellaneous Revenue Act of 1988; P.L. 100-647 30

S. Rep. 1567, 75th Cong., 3rd Sess. (1938), 1939-1 C.B. (Part 2) 815 . . 38

Rule 155, Computation by Parties for Entry of Decision, Tax Court Rules of Practice and Procedure. . . . 10, 42, 52

Andrews, Modern-Day Equitable Recoupment and the Two Tax Effect: Avoidance of the Statutes of Limitation in Federal Tax Controversies, 28 Ariz. L. Rev. 595 (1986) 28, 50

Mertens, Law of Federal Income Taxation, Ch 60.17 (June 1990 update, p. 31) 35

Note, The Equitable Recoupment Doctrine in *United States v. Dalm*: Where's the Equity?, 10 Virginia Tax Rev. 861 (1991) 17

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1991

CHARLES H. FALK and JOAN A. FALK, and
HILARY P. GARDNER and JUDITH C. GARDNER,

PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

CITATIONS OF OPINIONS BELOW

The Court of Appeals for the Third Circuit in Lerman, et al. v. Commissioner, 939 F.2d 44 (3rd Cir. 1991), cert. denied, Docket No. 91-628, December 2, 1991, affirmed the memorandum opinion of the Tax Court in Fox, et al. v. Commissioner, T.C. Memo 1988-50. By order dated November 22, 1991 the Court of Appeals for the Third Circuit *sub nom* Massey v.Commissioner, 3rd Cir. Docket

No. 91-1360, Nov. 22, 1991, affirmed without opinion the supplemental memorandum opinion of the Tax Court *sub nom* Kazi, et. al. v. Commissioner, T.C. Memo 1991-37, as to the petitioners whose appeal was to the Third Circuit.

The Court of Appeals for the Second Circuit in a *per curium* opinion *sub nom* Gardner v. Commissioner, 2nd Cir., Docket No. 90-9140(L), Jan. 22, 1992 affirmed the Kazi decision as to the petitioners whose appeal was to the Second Circuit.

The Tax Court memorandum opinion in Fox appears at 56 T.C.M. (CCH) 863 (1988); and in 1988 PH Memo T.C. ¶88,570. The supplemental memorandum opinion in Kazi appears in 61 T.C.M. 1759 (CCH) (1991); and in 1991 PH T.C. Memo ¶91,037.

The petitioners request for a writ of certiorari arises out of the issues addressed by the Tax Court in its supplemental memorandum opinion in Kazi.

The Lerman, Gardner, Fox, and Kazi opinions appear in the appendix.

JURISDICTION

The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1), and 26 U.S.C. §7482(a)(1).

STATUTES INVOLVED

The doctrine of equitable recoupment is judicially created. The pertinent parts of Sections 6214 and 7442 of the Internal Revenue Code of 1986, 26 U.S.C. §§6214, 7442, are as follows:

IRC §6214. DETERMINATIONS BY TAX COURT.

(a) Jurisdiction as to Increase of Deficiency, Additional Amounts, or Additions to the Tax.--Except as provided by section 7463, the Tax Court shall have jurisdiction to redetermine the correct amount of the deficiency even if the amount so redetermined is greater than the amount of the deficiency, notice of which has been mailed to the taxpayer, and to determine whether any additional amount, or any addition to the tax should be assessed, if claim therefor is asserted by the Secretary at or before the hearing or a rehearing.

(b) Jurisdiction Over Other Years and Quarters.--The Tax Court in redetermining a deficiency of income tax for any taxable year or of gift tax for any calendar year or calendar quarter shall consider such facts with relation to the taxes for other years or calendar quarters as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year or calendar quarter has been overpaid or underpaid.

IRC §7442. JURISDICTION.

The Tax Court and its divisions shall have jurisdiction as is conferred on them by this title, by chapters 1, 2, 3 and 4 of the Internal Revenue Code of 1939, by title II and title III of the Revenue Act of 1926 (44 Stat. 10-87), or by laws enacted subsequent to February 26, 1926.

STATEMENT OF THE CASE

The taxpayers-petitioners are commodities dealers.[1] Principally during the years 1975, 1976, and 1977 they incurred losses in commodities straddle transactions.[2] The Commissioner disallowed the claimed loss deductions and each taxpayer petitioned the Tax Court for a redetermination of the proposed deficiency.

As part of the Economic Recovery Tax Act of 1981 (ERTA), PL 97-34, Congress

---

[1] Taxpayers' wives are parties to this proceeding by virtue of filing joint returns with petitioner-husbands.

[2] In the prototype commodities straddle the dealer enters into a long and a short future or option position in the same commodity, which are regarded as balanced positions. Whichever way the price of the underlying physical commodity moves, one position, or leg of the straddle makes money, and the other yields a corresponding loss. The loss position is closed and the loss sustained is claimed on the tax return in the initial year of the transaction. A replacement position is acquired to retain the balanced nature of the offsetting positions. This closing of the loss leg, and its replacement is called a "switch". The gain leg and replacement position are both closed in the subsequent year, in which the taxpayer reports a gain corresponding to the loss taken in the prior year.

enacted definitive prospective rules for the treatment of commodities and other straddle transactions.[3] This legislation foreclosed the type of straddle transaction undertaken by the petitioners wherein the losses were reported in a taxable period prior to the reporting of the corresponding gain.

Subsequent to filing the Tax Court petitions Congress passed Section 108 of the Tax Reform Act of 1984[4], to address the administrative burden posed by thousands of pending straddle cases. Section 108 provided definitive rules for disputed pre-ERTA transactions.

---

[3] Title V of the Economic Recovery Tax Act of 1981, P.L. 97-34, §§501 *et seq.*, added Sections 1092 (loss deferral rule) and 1256 (mark-to-market) to the Internal Revenue Code. 26 U.S.C. §§1092, 1256.

[4] Section 108 refers to Section 108 of the Tax Reform Act of 1984, PL 98-368, §108, as amended. Section 108 is reproduced in the appendix. Unless otherwise noted, all other statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended.

Following Section 108's misinterpretation by the Tax Court, Section 108 was amended by the Tax Reform Act of 1986, PL 99-514, §1808(d), to provide a *per se* rule of allowance of losses for dealer straddle transactions. The Tax Court determined that the petitioners were not entitled to relief under Section 108 because their transactions were lacking in economic substance.[5] The Tax Court also held that since the straddle transactions were

---

[5] The Tax Court rendered its opinion in Fox v. Commissioner, T.C. Memo 1988-50. Taxpayers Falk, Gardner, and Lerman, among others, sought review of the Tax Court opinion in the Courts of Appeals. Petitioners Falk and Gardner appealed to the Court of Appeals for the Second Circuit, and Lerman appealed to the Court of Appeals for the Third Circuit. Venue was determined by the petitioner's residence at the time of filing his respective Tax Court petition. 26 U.S.C. §7482(b)(1). The Third Circuit affirmed the determination of the Tax Court in Lerman v. Commissioner, 939 F.2d 44 (3rd Cir. 1991), cert denied, ___U.S.___, Docket No. 91-628, Dec. 2, 1991. The Second Circuit affirmed the Tax Court in Gardner v. Commissioner, Docket No. 90-4140(L), Jan. 22, 1992.

Petitioners Falk and Gardner, and Lerman have each filed Petitions for Writ of Certiorari to their respective Courts of Appeals, and have requested that the Clerk of the Court assign them consecutive docket numbers and consider them together.

shams, gains reported by petitioners in the latter years do not constitute taxable income to them (App. A39).

In calendar years subsequent to those before the Tax Court petitioners Falk, Gardner, and Lerman reported net long-term capital gains from commodities straddle transactions on which they paid substantial amounts of tax. The gains so reported were realized on the closing of the gain legs of the straddles which gave rise to the losses disallowed by the Tax Court. For unexplained reasons, no claim for refund was filed in support of the taxes thus paid and recovery of such taxes is barred by the Statute of Limitations.[6]

---

[6] The refusal of the Commissioner to allow credit for such payments as an offset to the deficiencies has the effect of increasing the payments which the Government will receive, over and above that to which it is entitled, by millions of dollars. For the year 1979 petitioners Falk and Gardner reported net long-term capital gains from commodities straddle

(continued...)

26 U.S.C. §§6511, 6512, 6532.

In a proceeding under Rule 155[7] in the Tax Court petitioners argued for relief on the alternative grounds of (*i*) equitable recoupment or (*ii*) equitable estoppel from the unconscionable position of the Commissioner that the petitioners pay tax twice on the same income.

Under the doctrine of equitable recoupment the taxpayers would receive credit in an open year before the Court in which the Commissioner asserted a liability for the amount of tax paid in a closed year attributable to a corresponding straddle gain. Under the

---

[6](...continued)
transactions in the amounts of $1,348,422, and $1,692,886, on which they made payments of $350,819 and $468,114, respectively. For the year 1977 petitioner Lerman reported net long-term capital gain from commodities straddle transactions of $332,182, on which he made tax payments of $80,128.

[7] Rule 155, Computation by Parties for Entry of Decision, Tax Court Rules of Practice and Procedure.

doctrine of equitable estoppel, as applied to this case, the Commissioner would be estopped from disallowing reported straddle losses to the extent of net income attributable to corresponding gains in subsequent barred years. Thus the estoppel computation envisages a netting of erroneously reported taxable income against disallowed losses.

The Tax Court in its supplemental memorandum opinion *sub nom* Kazi v. Commissioner, *supra*, held that it does not have equitable recoupment jurisdiction (App. A21,22). The Tax Court did not address the equitable estoppel argument. The Kazi decision was affirmed on appeal[8], and the instant petition followed.

---

[8]The Court of Appeals for the Third Circuit affirmed the opinion of the Tax Court in its Judgment Order, without opinion, *sub nom* Massey v. Commissioner, *supra*, Nov.2, 1991. The Court of Appeals for the Second Circuit affirmed in Gardner v. Commissioner, *supra*, Jan. 22,1992.

REASONS FOR GRANTING THE WRIT
UNDER THE DOCTRINES OF EQUITABLE RECOUPMENT OR EQUITABLE ESTOPPEL, PETITIONERS SHOULD EITHER RECEIVE CREDIT FOR TAX PAID ON NET STRADDLE GAINS (RECOUPMENT) OR BE ALLOWED TO OFFSET NET STRADDLE GAINS REPORTED IN YEARS BARRED BY THE STATUTE OF LIMITATIONS AGAINST DISALLOWED LOSSES (ESTOPPEL).

A. EQUITABLE RECOUPMENT

Succinctly stated, this Court's recent decision in United States v. Dalm, ___U.S.___, 58 U.S.L.W 4355, 110 S.Ct. 1361 (1990), left open the issue of the Tax Court's jurisdiction to apply the doctrine of equitable recoupment. That issue was not presented in Dalm. These cases raise the issue squarely.

Equitable recoupment is a judicial doctrine which allows both a taxpayer and the Internal Revenue Service to avoid the bar of the statute of limitations to prevent inconsistent tax treatment of a single transaction or event with regard

to a single taxpayer. All of the elements for application of the doctrine are currently present: the same transaction (or, as the Tax Court held, non-transaction) or taxable event, is involved; the taxpayer in each case is identical; the Government will be unjustly enriched by reaping the benefit of a tax paid on an otherwise nonexistent and unrecognized transaction; and the taxpayers' recovery of taxes paid in error is barred by the statute of limitations.

This Court recently analyzed the doctrine of equitable recoupment in United States v. Dalm, *supra*. In Dalm the taxpayer had received payments of money in 1976 and 1977 from the brother of the decedent of whose estate Dalm was the administratrix. Gift tax returns were filed for the payments and Dalm paid the tax for 1976. On subsequent audit,

the Internal Revenue Service determined that the payments were income to Dalm, and Dalm contested the proposed deficiencies in the Tax Court. No claim for a credit of the gift tax paid by Dalm was raised in the Tax Court proceeding. Dalm, 110 S.Ct. at 1363. A settlement was reached and after paying the income tax deficiency Dalm commenced an action in the District Court for refund of "overpaid gift tax". A gift tax refund claim was filed, and the taxpayer's suit commenced, long after the statute of limitations had run. Thus, the taxpayer was not invoking the doctrine as an off-set of a time barred claim against an open claim, but as the basis for jurisdiction for an untimely refund suit. The Supreme Court held that the doctrine of equitable recoupment could not serve as the sole basis for jurisdiction. It concluded that the general principle of

sovereign immunity could not be overcome solely by equitable considerations, and that the defense of equitable recoupment was available only when a court otherwise had jurisdiction over the tax liability inconsistently asserted.

> Here the Government asserted an income tax deficiency on a theory inconsistent with the theory upon which Dalm relied in paying gift tax. She chose to litigate the deficiency in the Tax Court, where she did not attempt to raise a recoupment claim.[8] She cannot choose this avenue to adjudicate the income tax consequences of the transaction, and then seek to reopen the matter and override the statute of limitations for the sole purpose of seeking recoupment. The controlling jurisdictional statutes do not permit her to do so.

> 8. We have no occasion to pass upon the question whether Dalm could have raised a recoupment claim in the Tax Court. (110 S.Ct. at 1370)

There is no question that the Tax Court has proper jurisdiction over the petitioners for the years 1975, 1976 and

1977. Thus, petitioners may, under the authority of Dalm, raise the doctrine of equitable recoupment in order to receive credit against the deficiencies for the taxes they paid on straddle gains reported in the time barred years.

Dalm makes it clear that if the petitioners had paid the deficiencies proposed by the Commissioner and had instituted timely suit in the District Court to recover the taxes paid on the disallowed losses, they would have been able to invoke the doctrine of equitable recoupment to obtain refunds of the otherwise barred payments. As the Court said:

> Our holding today does not leave taxpayers in Dalm's position powerless to invoke the doctrine of equitable recoupment....and a court which has jurisdiction over a timely suit for refund may consider an equitable recoupment claim for an earlier tax paid under an inconsistent theory on the same transaction. (110 S.Ct. at 1369.)

Petitioners contend that the Tax Court does have the authority to allow equitable recoupment notwithstanding the conventional wisdom that the Tax Court lacks equitable jurisdiction to do so. There are numerous reasons why this is so. The fact that the Supreme Court expressly reserved the issue in footnote 8 establishes that the issue is an open one.[9]

As Justice Stevens pointed out in his dissent (110 S.Ct. at 1372, note 3) the proposition that the Tax Court lacks jurisdiction to consider equitable recoupment proceeds from a misreading of

---

[9] Given the cursory treatment accorded the issue by the lower courts, only this Court can resolve this issue now that it has arisen. Failure to resolve an issue it has acknowledged has merit will provide grist for the commentators as did the famous footnote 37 of Crane v. Commissioner, 331 U.S. 1, note 37 (1946). See, e.g., Note, The Equitable Recoupment Doctrine in *United States v. Dalm*: Where's the Equity?, 10 Virginia Tax Rev. 861 (1991). It took this Court 37 years to resolve the Crane issue in Tufts v. Commissioner, 431 U.S. 300 (1983). This case allows for readier resolution of the issue raised in footnote 8 of Dalm.

Commissioner v. Gooch Milling & Elevator Co., 320 U.S. 418 (1943), and he commended the majority for leaving the question open. Thus, all members of the Supreme Court have agreed that the issue of the Tax Court's jurisdiction is not foreclosed, rendering reliance on Gooch Milling and its progeny tenuous.[10]

The Tax Court held in Kazi that it was without jurisdiction to grant equitable relief of the character sought by petitioners. A close examination of the authorities cited in the Kazi opinion, from which this petition arises, reveals the lack of consideration the Tax Court has traditionally given to this issue. The Tax Court, citing Woods v. Commissioner, 92 T.C. 776, 787 (1989); Phillips Petroleum Co. v. Commissioner,

---

[10] The error alluded to is a misinterpretation of Section 6214(b). For the reasons discussed, below, Section 6214(b) is not a bar to equitable recoupment.

92 T.C. 885, 889-890 (1989), and Knapp v. Commissioner, 90 T.C. 430, 440 (1988), aff'd. 867 F.2d 749 (2nd Cir. 1989), stated in this case that, "It is well established that as a court of limited jurisdiction we cannot expand our jurisdiction by granting equitable relief." (Supplemental Memorandum Opinion, App. A21) The Court was clearly wrong. The Tax Court does have the authority to allow equitable recoupment and the Court's statement, though often repeated, is neither well established nor correct.

Woods and Phillip's Petroleum, both held that the Tax Court does indeed have the authority to apply equitable principles in reaching its decision. See the numerous examples referred to in Woods, 92 T.C. 776, at 784, 785, discussed at pp. 36, 37, *infra*. Woods also stands for the proposition that

Congress intended the Tax Court to have full judicial authority to resolve issues over which it has jurisdiction, without bifurcating proceedings by reserving issues to the District Court. 92 T.C. 776, at 788.

In Phillip's Petroleum Co., supra, recoupment was not possible because the Tax Court did not have jurisdiction over the excise tax imposed by Section 4371, which the petitioners sought to offset against an income tax deficiency; thus the issue was lack of statutory, not equitable, jurisdiction.

The Court's reliance on Knapp is even more bewildering. The Tax Court did indeed repeat therein the generality that it lacked the ability to apply equitable principles to expand its jurisdiction, and the case was affirmed. However, the Tax Court was clearly reversed as to this issue, and this Court adopted the

expansive view pronounced in Woods, supra, that the Tax Court is intended to have full authority to resolve all necessary issues to redetermine a deficiency. In Knapp the issue was whether the Tax Court could consider and grant relief under the so called Fringe Benefit Moratorium, Section 1, Pub. L. 99-427, 92 Stat. 996 (1978). The Court of Appeals stated:

> The Moratorium statutorily ...bars the Commissioner from issuing any regulations concerning the tax status of a fringe benefit. Absent from the Moratorium, however, was a clause granting the Tax Court jurisdiction to enforce its terms. Consequently, the Commissioner argues [and the Tax Court held] that the Tax Court lacks authority to compel compliance with the Moratorium. We disagree.
>
> The Tax Court is a court of limited jurisdiction, see Taylor v. Commissioner, 258 F.2d 89, 93 (2d Cir. 1958), possessing only those powers expressly conferred upon it by Congress. One of these powers, however, is the authority "to redetermine the correct amount of [a] deficiency" in income tax, 26 U.S.C. §6214 (Supp. IV 1986), and to

> review both law and fact with respect to deficiencies. Dobson v. Commissioner, 320 U.S. 489, 501 (1943). As an incident to these functions, the Tax Court must hear challenges to the validity of regulations in redetermining deficiencies. CSX Corp. v. Commissioner, 89 T.C. 134, 143-46 (1987). Because the Moratorium clearly affects the validity of regulations promulgated after the specified dates, the Tax Court is not only empowered, but also obligated, to apply it when it is relevant to a redetermination of a challenged deficiency. In the present case, therefore, the Tax Court should have considered the Moratorium's provisions when examining the Commissioner's assertion of a deficiency. 867 F.2d 749, at 753 (1989).

Though the Tax Court's cited authorities appear ill considered, even more profound is the Court's failure to consider the impact of this Court's decision in United States v. Dalm, supra.

The Commissioner in the courts below offered a laundry list of cases in support of the proposition that the Tax Court lacks equitable jurisdiction. Equally telling is an analysis of those

authorities. The Commissioner's principal argument in opposition is that the jurisdiction of the Tax Court is limited to the redetermination of deficiencies in income, estate and gift, and certain excise taxes, citing in support of that proposition, Commissioner v. McCoy, 484 U.S. 3 (1987). The principle is true as a generality but it is inapplicable, as McCoy is inapplicable to the case at hand, for clearly the Tax Court had jurisdiction to determine the deficiencies and was being asked merely to apply equitable principals in the process. See, Woods v. Commissioner, 92 T.C. 776, 785 (1989) ...

> It has been stated that "The Tax Court is a court of limited jurisdiction and lacks general equitable powers." Commissioner v. McCoy, 484 U.S. 3, 7 (1987). However, the context in which this statement was made involved the question of whether an appellate court reviewing a decision of the Tax Court could order relief "to achieve a fair and just result" even

> though the Tax Court had no jurisdiction over the subject matter of that relief. Commissioner v. McCoy, 484 U.S. at 6. The Supreme Court held that the appellate court's authority was restricted to review those matters over which the Tax Court had jurisdiction and that the Tax Court could not expand that jurisdiction based upon equitable considerations. Given the context in which it was made, the above quoted statement simply means that we lack general equitable powers to expand our statutorily prescribed jurisdiction. For example, in a recent opinion, the Sixth Circuit, while recognizing the existence of Commissioner v. McCoy, supra, held that the equitable principle of "judicial estoppel" should be applied by this Court in deciding a deficiency over which we had jurisdiction. Reynolds v. Commissioner, 861 F.2d 469 (6th Cir. 1988), revg. a Memorandum Opinion of this Court. [Emphasis added]

Reynolds v. Commissioner, 861 F. 2d 469 (6th Cir. 1988), involved the application of the doctrine of judicial estoppel. In response to the objection that the Court of Appeals had no greater jurisdiction in reviewing Tax Court decisions than the Tax Court had in the first instance - and that the Tax Court

did not have equitable jurisdiction - the Court of Appeals noted:

> As an initial matter, we consider a possible jurisdictional obstacle to petitioner's invoking the doctrine of judicial estoppel in this case. Judicial estoppel has been viewed as an equitable doctrine governed by general equitable principles. Comment, Precluding Inconsistent Statements: The Doctrine of Judicial Estoppel, 60 Nw. U.L. Rev. 1244, 1261 (1986); see also 18 C. Wright, A. Miller & E. Cooper, Federal Practice and Procedures §4477 (1981). The Tax Court, however, does not have general equitable powers. Commissioner v. McCoy, 484 U.S. __, _____, 108 S.Ct. 217, 219, 98 L.Ed.2d 2 (1987) (per curiam). Courts of Appeals, in reviewing Tax Court decisions, have no greater jurisdiction than the Tax Court had in the first instance. Id. Taxpayers who anticipate raising such equitable defenses as judicial estoppel, it has been argued, must do so in the district courts, paying the deficiency first and then bringing suit for a refund. T. Lynn and M. Gerson, Quasi-Estoppel and Abuse of Discretion as Applied Against the United States in Federal Tax Controversies, 19 Tax L.Rev. 487, 516-520 (1964).
>
> This approach, while not unpersuasive as a matter of statutory construction, has not been followed by the Tax Court or the

> courts of appeals in equitable estoppel cases. 861 F.2d at 472. [Citations omitted, emphasis added]

The statement relied on by Commissioner in Estate of Schneider v. Commissioner, 93 T.C. 568 (1989), that the Tax Court lacked jurisdiction to consider equitable recoupment is not indicative of the Tax Court's position on this issue when viewed in the context of the unique procedural aspects of that case. Rather it is another example of the lack of analysis that the Tax Court has given this issue. In Schneider, the Court held for the Commissioner on certain controverted issues. The Estate filed an appeal bond and appealed the Tax Court's decision, which was affirmed by the Court of Appeals for the 7th Circuit. After the affirmance, the Commissioner sought to liquidate the appeal bond and apply the proceeds to the deficiency. Only then did the taxpayer claim an

offset on account of alleged overpayment. Thus, in Schneider the claim for relief did not occur in a case in which the Tax Court had jurisdiction at all. Jurisdiction was transferred to the Court of Appeals following the filing of the notice of appeal, and the decision became final upon its subsequent affirmance. The doctrine of *res judicata* made it inappropriate to raise any new issue thereafter, including one based on an equitable remedy.

It will be seen therefore, that reliance on pre-Dalm teching is unavailing.

The doctrine of equitable recoupment had its genesis in Bull v. United States, 295 U.S. 247 (1935). Recoupment was granted, and the doctrine firmly established, in a case which in fact, arose in the Board of Tax Appeals, the predecessor of the Tax Court. In Bull,

the executor of the decedent's estate included certain payments in the gross estate and paid the estate tax thereon. Subsequently, the Commissioner asserted a deficiency in income tax against the estate on the theory that the amounts received constituted income to the estate. The Board of Tax Appeals sustained the Commissioner's determination and the executor paid the income tax deficiency. Thereafter, the executor filed a claim for refund of the income tax and commenced a suit for refund in the Court of Claims after the claim was denied.[11]

---

[11] This procedure is notably different than that which would apply today. Prior to the enactment of the Revenue Act of 1926, a taxpayer was allowed to sue for refund after payment of a deficiency determined by the Board of Tax Appeals because there was then no direct review of Board decisions. Review was obtained in a separate action after payment of the deficiency determined by the Board. The Revenue Act of 1926 substituted direct judicial review by the Circuit Courts of Appeals of Board decisions. See generally, Andrews, Modern-Day Equitable Recoupment and the Two Tax Effect: Avoidance of

(continued...)

The Court of Claims in Bull rejected the theory of recoupment as a basis for recovery and was reversed by the Supreme Court. Thus, the doctrine had its inception in a case arising out of review of a Board of Tax Appeals opinion.[12] It is certainly anomalous to conclude that as the Board's, and subsequently the Tax Court's, status as an independent judicial tribunal has grown, by virtue of the Revenue Act of 1926 and subsequent legislation, its jurisdiction has been

---

[11](...continued)
the Statutes of Limitation in Federal Tax Controversies, 28 Ariz. L. Rev. 595, at 599 note 20 (1986).

[12] As the Supreme Court noted in its footnote 4 to the Dalm opinion, the Court of Claims refund suit "although nominally a separate proceeding, was a mechanism by which taxpayers could obtain review of Board decisions." Was not the Supreme Court saying that the matter was one for decision by the Board (Tax Court) in the first instance? Indeed, failure to raise the claim in the Tax Court may amount to a waiver. See the quote from Dalm, 110 S.Ct. at 1367, which follows in the text, *infra*, at pp. 31, 32.

reduced.[13] Substantively, petitioners point out that the Board of Tax Appeals and the Tax Court were created to enable taxpayers-- particularly less affluent ones-- to contest their tax liability without having first to pay the tax. All the members of the Supreme Court agreed that Dalm could have invoked the doctrine had she paid the disputed income taxes and sued for a refund. A conception of the Tax Court's jurisdiction which makes

---

[13] Numerous Acts have expanded, but never restricted, the authority of the Tax Court. See, e.g., the Tax Reform Act of 1969, PL 91-172, Section 951, establishing the Tax Court under Article I of the Constitution. Section 961 of the Tax Reform Act of 1969, provided in part that the U.S. Tax Court established by the amendment is a continuation of the Tax Court of the United States (previously the Board of Tax Appeals)...and no loss of rights or powers, interpretation or jurisdiction...shall result from the enactment.... Among other enhancements, Tax Court jurisdiction has been expanded to include declaratory judgments (IRC Sections 7476, 7478; Revenue Act of 1978, P.L. 95-600, Section 336); interest determinations and review of jeopardy assessments (IRC Sections 7429(a)(2)(B) and 7481(c); Technical and Miscellaneous Revenue Act of 1988; P.L. 100-647, Sections 6237(c) and 6246).

the remedy available only to those able to pay the full amount claimed by the Internal Revenue Service in its statutory notice[14] runs counter to the principles which underlie the Tax Court's creation. Congress intended the Tax Court to have full judicial authority to resolve issues over which it has jurisdiction, without bifurcating proceedings by reserving issues to the District Courts. Woods, 92 T.C. 776, at 788.

The Supreme Court stated:

> No claim for a credit or recoupment of the gift tax paid by Dalm was raised in the Tax Court proceeding... (110 S.Ct. at 1363)
>
> ...
>
> ...Here, Dalm does not seek to

---

[14] An amount which, as is commonly known, is utilized by the Internal Revenue Service as a means of inducing settlement, or by reason of taking alternative inconsistent positions, is frequently greatly exaggerated. For example, here the Commissioner in his deficiency notices took the inconsistent positions of disallowing reported commodities straddle losses but not gains, thus generating grossly excessive proposed deficiencies, leaving the taxpayers to their own devises to prevent an unjust result.

> invoke equitable recoupment in determining her income tax liability; she has already litigated that liability [in the Tax Court] without raising a claim of equitable recoupment, and is foreclosed from relitigating it now.... (110 S.Ct. at 1367)

If the Court were of the view that resort to the Tax Court was foreclosed because of that tribunal's restricted jurisdiction why, petitioners inquire, did the Court take pains to point out that Dalm had not invoked the aid of the Tax Court? Why should the Court conclude that Dalm is precluded from *relitigating* the question of equitable recoupment in the District Court if she could not have litigated it in the Tax Court in the first instance? We suggest that the Supreme Court has intimated its contrary views on the subject, and it is now called upon to make those views plain.

It may well be that the precise limits of the Tax Court's jurisdiction

need not be determined at this time and credit for taxes paid on fictitious gains may be allowed to the taxpayers on the basis of Bull v. United States, 295 U.S. 247 (1935) as explicated by the Supreme Court in Dalm (110 S.Ct. at 1366):

> What did occur, however, was that after the limitations period on the estate tax had run, the Government assessed a deficiency in the estate's income tax based upon the same taxable event, and the deficiency became the subject of litigation between the estate and the Government. We reasoned that a tax assessment is in essence an assertion by the sovereign that the taxpayer owes a debt to it; but that, because "taxes are the life-blood of government," it was necessary for the tax assessed to be collected prior to adjudication of whether the assessment was erroneous or unlawful. As a result,
>
> > "the usual procedure for the recovery of debts is reversed in the field of taxation. Payment precedes defense, and the burden of proof, normally on the claimant, is shifted to the taxpayer....But these reversals of the normal process of collecting a claim cannot obscure the fact that after all what is being accomplished is the recovery of a just debt

owed the sovereign." Id., at 260.

Under our reasoning, the proceeding between the executor and the Government was in substance an attempt by the Government to recover a debt from the estate. The debt was the income tax that was owed, even though in fact it already had been paid. Had the Government followed the "usual procedure" of recovering debts by instituting an action at law for the income tax owed, the executor would have been able to defend against the suit by "demanding recoupment of the amount mistakenly collected as estate tax and wrongfully retained." Id., at 261 (citing United States v. State Bank, 96 U.S. 30 (1878)).

"If the claim for income tax deficiency had been the subject of a suit, any counter demand for recoupment of the overpayment of estate tax could have been asserted by way of defense and credit obtained notwithstanding the statute of limitations had barred an independent suit against the Government therefor. This is because recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded. Such a defense is never barred by the statute of limitations so long as the main action itself is timely." 295 U.S., at 262. (Emphasis added)

Viewed from this perspective, the Tax Court is not being asked to provide equitable relief or an equitable remedy; that is, relief other than in the form of a money judgment. Rather, the Court is merely being asked to redetermine the deficiencies for the years involved, taking into account the equitable principle that where the Government seeks to collect a debt (e.g., if it were the plaintiff in a suit to collect income taxes due it) one may demand "recoupment of the amount mistakenly collected and wrongfully retained..." Otherwise stated, the Court is being asked to refuse to assert its authority in support of an indefensible and unjust result. This the Tax Court has ample authority to do.

The Tax Court clearly has the power to use equitable principles in reaching its decisions. Mertens, Law of Federal

Income Taxation, Ch 60.17 (June 1990 update, p. 31); Reynolds v. Commissioner, 861 F.2d 469 (6th Cir. 1988); Woods, *supra*; Phillip's Petroleum Company, 92 f.c. 885 (1989), and the cases cited therein.

As the Court noted in Woods, 92 T.C. 776, at 784, 785:

> An historical analysis of our cases discloses numerous instances where we have applied equitable principles in deciding issues over which we had jurisdiction. For example, we have applied the equity-based principles of waiver,[3] duty of consistency,[4] estoppel,[5] substantial compliance,[6] abuse of discretion,[7] laches,[8] and the tax benefit rule.[9] "While we cannot expand our jurisdiction through equitable principles, we can apply equitable principles in the disposition of cases that come within our jurisdiction." Berkery v. Commissioner, 90 T.C. 259, 270 (1988) (Hamblen, J., concurring).

---

[3] Armco, Inc. v. Commissioner, 88 T.C. 946, 963 n8 (1987); Aero Rental v. Commissioner, 64 T.C. 331,338 (1975).

[4] Unvert v. Commissioner, 72 T.C. 807, 814-17(1979), aff'd. 656 F.2d 483 (9th Cir. 1981); Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82 (1971), aff'd. per curiam 456 F.2d 622 (5th Cir. 1972).

[5] Boulez v. Commissioner, 76 T.C. 209, 214-17(1981), aff'd. 810 F.2d 209 (D.C. Cir. 1987).

[6] Taylor v. Commissioner, 67 T.C. 1071, 1077-78 (1977).

[7] Estate of Gardner v. Commissioner, 82 T.C. 989, (1984).

[8] Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 840 (1980).

[9] Rojas v. Commissioner, 90 T.C. 1090 (1988), on appeal, (9th Cir., Dec. 9, 1988).

Thus, assuming, arguendo, that the Tax Court does not have equitable jurisdiction, it may nevertheless redetermine the amount of a deficiency, its clear statutory duty, while applying equitable principles in the process.[15]

As noted by the dissent in Woods, 92

---

[15] In Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983), the Supreme Court recognized "transactional equity" as the rationale for the tax benefit rule. 460 U.S. 370, 388. There is no jurisdictional impediment to the Tax Court's application of this equitably based doctrine. There is simply no rational justification for the Tax Court to restrict itself to the particular equitable remedies which it has identified (e.g., tax benefit, claim of right, duty of consistency), all of which were devised to deal with transactions originating in years for which adjustment is precluded, while forbidding itself resort to recoupment, another concept of transactional equity of judicial creation.

T.C. at 793, recoupment is not an exercise of solely equitable jurisdiction:

> Finally, it appears that the majority may be misled by the word "equitable" in the term "equitable recoupment." As Professor Dubroff points out (H. Dubroff, United States Tax Court--An Historical Analysis, p. 484 (1979)) equitable recoupment is--a doctrine developed and applied by both the courts of common law and equity[873]* * * *

---

[873] McConnell, "Doctrine of Recoupment in Federal Taxation." 28 Va. L. Rev. 577, 579-84 (1942).

The Commissioner is not protecting the revenue, the tax has been paid: rather he is using the statutory bar to obtain an unfair result. Congress never intended such active exploitation of the statute of limitations, which is merely designed to prevent the litigation of stale claims. See S. Rep. 1567, 75th Cong., 3rd Sess. (1938), 1939-1 C.B. (Part 2) 815, quoted in Woods, *supra*, at 786, n12.

A taxpayer has, in some instances, a choice of forums within which to address the merits of an adverse tax determination of the Internal Revenue Service. He may chose the Tax Court, District Courts, or the Court of Claims. There are various differences in the procedural rights accorded parties in each forum. The Tax Court permits a pre-assessment determination of the correct amount of a deficiency, while the taxpayer must seek a refund in the District Courts or the Court of Claims. A prerequisite to filing a Tax Court petition is receipt of a notice of deficiency, while a claim for refund is a prerequisite to a refund suit. 26 U.S.C. §§6532, 7422; Flora v. United States, 362 U.S.145 (1960), *decision on rehearing of* 357 U.S. 63 (1960). A taxpayer is entitled to a trial by jury in the District Courts only. 28 U.S.C. §2402.

Lack of a right to demand a jury in the other forums has been held not to be a denial of due process despite the language of the Seventh Amendment. See, e.g., United States v. Sherwood, 312 U.S. 584 (1941); Phillips v. Commisioner, 283 U.S. 589, 599 n.9 (1931). A taxpayer in a refund suit must establish that he is entitled to a refund and put all aspects of his liability in issue, while in the Tax Court the proposed deficiency is redetermined (subject to the Court's ability to find a greater or lesser deficiency or a refund). Lewis v. Reynolds, 284 U.S. 281 (1932).

Each of these is a difference in a taxpayer's procedural, but not substantive, rights of adjudication of a tax dispute. On the other hand, the Tax Court's disavowal of the ability to apply the doctrine of equitable recoupment leads to a substantive denial of due

process, because the Court has precluded itself from determining the correct amount of a deficiency. Taxpayers in the same factual circumstances, who have cases adjudicated in different forums, could be found to have different liabilities. Congress clearly did not intend to create such differences for similarly situated taxpayers. Through the application of equitable principles, the Court can estop the Commissioner from achieving this injustice.

Only Commissioner v. Gooch Milling & Elevator Co., 320 U.S. 418 (1943), seems to impose an obstacle to allowing petitioners the setoffs to which they are clearly entitled; but Gooch is distinguishable in that Section 6214(b) (originally enacted as Section 274(g) of the Revenue Act of 1926, 44 Stat. 2) upon which Gooch is founded does not preclude this Court from offsetting the

taxes paid by petitioners on their phantom gains against the putative deficiencies.[16] The calculations contained in the Petitioners Alternative Computations for Entry of Decision offered in the Tax Court Rule 155 proceeding are not calculations of a deficiency or overpayment for barred years such as is precluded by Section 6214(b). The taxes for the barred years stand as paid and the years are not being reopened for any purpose: no deficiency nor overpayment for a barred year is to be determined, but only an amount which the Commissioner will be precluded from assessing in the interest of preventing a grave injustice. Section 6214(b), when carefully read, mandates the action

---

[16] The statement in Rothensies v. Electric Battery Co., 329 U.S. 296 (1946), that the Tax Court lacks jurisdiction to consider a claim of equitable jurisdiction relied upon Gooch Milling, *supra*.

appellants are requesting the Court to take:

> The Tax Court in redetermining a deficiency of income tax for any taxable year..***shall consider such facts with relation to the taxes for other years***...as may be necessary correctly to redetermine the amount of such deficiency... IRC Section 6214(b).

Surely, the Tax Court can not be allowed to ignore the *fact* that the transactions in issue resulted in the erroneous taxation of income in another year.

The Tax Court's jurisdiction is established by Section 6214(a) which provides that the Tax Court shall have jurisdiction to redetermine the correct amount of the deficiency. Such redetermination is embodied in a decision of the Tax Court which becomes final in accordance with Section 7481. Petitioners construe the final phrase of Section 6214(b) to mean only that the Tax Court is precluded from entering a decision

redetermining the correct amount of tax for a year not before it and determining, in respect of such year, that there is a deficiency or an overassessment. "Determination" and "redetermination" are words of art as used in the Code and mean a decision of the Court finding a deficiency (to be paid by the taxpayers) or a refund (to be paid by the Commissioner). It does not mean that the Court is precluded from computing the amount of tax for another year when it is necessary to consider the amount of tax attributable to that year as a necessary factor for determining the deficiency for the year before it. The Tax Court clearly shares this interpretation.[17]

---

[17] In Lone Manor Farms, Inc. v. Commissioner, 61 T.C. 436 (1974), aff'd in an unpublished opinion, 3rd Cir., Jan. 27, 1975, the Court stated:

> It is well settled that we may determine the correct amount of taxable income or net operating loss for a year not
>
> (continued...)

[17](...continued)
in issue (whether or not the assessment of a deficiency for that year is barred) as a preliminary step in determining the correct amount of a net operating loss carryover to a taxable year in issue. ABKCO Industries, Inc., 56 T.C. 1083, 1088-1089 (1971), affirmed on another issue 482 F.2d 150 (C.A. 3, 1973), and cases cited therein. See also Anthony Mennuto, 56 T.C. 910, 923 (1971), involving the analogous determination of an investment credit carryover, and cases cited therein. But petitioner argues that such cases are not precedents for what respondent asks us to do in this case, namely, to recompute the tax for a barred year and not just the correct taxable income or net operating loss for such a year. It is such a recomputation of the tax for a year not in issue that, according to petitioner, section 6214(b) prohibits by providing--

> The Tax Court...shall have no jurisdiction to determine whether or not the tax for any other year has been overpaid or underpaid.

We think that petitioner misconceives the import of Section 6214(b). It is true that respondent's disallowance of petitioner's claimed net operating loss deduction for 1969 depends on a determination that Section 1201 does not apply to petitioner's taxable year 1967 because a recomputation of the regular tax for 1967 shows that it is less than the alternative tax. What concerns us in this proceeding, however, is not the correct amount of petitioner's tax liability for 1967 but the deductions to be used in correctly calculating that amount, whether under Section 11 or Section 1201.

Section 6214(b) says that we have no power to determine an overpayment or underpayment of tax for a year not is issue which would form the basis of a refund suit

(continued...)

[17](...continued)
or an assessment of a deficiency. Commissioner v. Gooch Co., 320 U.S. 418 (1943) (decided under the predecessor of present Section 6214(b). See also Robbins Tire & Rubber Co., 53 T.C. 275, 279 (1969). It does not prevent us from computing, as distinguished from "determining," the correct tax liability for a year not in issue when such a computation is necessary to a determination of the correct tax liability for a year that has been placed in issue, Commissioner v. Gooch Co., supra, 320 U.S. at 420-421 and fn. 5; Lawrence W. Carpenter, 10 T.C. 64, 66-68 (1948); J.C. Blair Co., 11 B.T.A. 673, 679 (1928); D.N. & E. Walter & Co., Inc., et al., 10 B.T.A. 867, 876-877 (1927). Nor is the rationale of the decided cases limited to situations where the recomputation of the tax liability for the barred year involves the propriety of omissions or deductions from gross income for such year; it extends to a recomputation of the tax liability itself, even though no adjustments are made to taxable income. Anthony Mennuto, supra. 61 T.C. at 440, 41 (emphasis added).

Petitioners' interpretation of Section 6214(b) is reinforced by the Tax Court's recent opinion in Calumet Industries, Inc. v. Commissioner, 95 T.C. 257 (1990). In that case, the Commissioner sought to recompute a net operating loss arising in 1981, a closed year, for the purpose of reducing the amount of the NOL carryback to 1979, an open year, for the purpose of asserting a deficiency with respect to the open year. The Tax Court determined that the Commissioner was not barred from assessing a deficiency for an open year where his determination did not concern additional assessments for a barred year, but only review of a computation from a barred year for the purpose of correctly determining the tax liability for an open year. The Tax Court was not being asked to determine an underpayment for the closed year--no redetermination of tax liability, no deficiency, was being sought for the closed year because of

(continued...)

---

[17](...continued)
the recomputation of the NOL for that year--and consequently there was no violation of the prohibition of 6214(b). Similarly, since the petitioners here are not asking this Court to redetermine the tax for the barred years and find that there was an overpayment giving rise to a refund for such years, the requested relief does not run afoul of the prohibition.

More recently, in Hill v. Commissioner, 95 T.C. 437 (1990), the issue was whether the Commissioner could recompute the tax for a prior year for which assessment was barred and, because of an increase in the tax so recomputed, reduce the amount of an investment credit carried over to the year in issue. The Court held for the Commissioner, in effect allowing the Commissioner to recover additional tax otherwise barred by the statute, without determining a deficiency for the barred year. The Court stated:

> Before concluding our discussion of Section 6214(b), however, we would like to draw attention to the first sentence of the second paragraph of that portion of our opinion in Lone Manor Farms set forth above. 61 T.C. at 440. In full, that sentence reads: "Section 6214(b) says that we have no power to determine an overpayment or underpayment of tax for a year not in issue which would form the basis of a refund suit or an assessment of a deficiency." (Emphasis added). The underlined phrase, which, admittedly, adds a gloss to the statute, we think accurately identifies Congress' concern in depriving us of jurisdiction to determine an overpayment or underpayment for a prior year. Simply put, we may not determine an overpayment or underpayment of tax for a prior year so as to entitle a taxpayer to a refund for that year or give to respondent the authority to assess or collect a tax for that year. Thus, were respondent's adjustments with respect to 1981 to result in an increased liability for that year, in excess of any available credit, we would
>
> (continued...)

Thus its continued misreading of Gooch Milling is all the more mystifying.

The Commissioner would obfuscate the issue by suggesting that the petitioners were guilty of some species of inequitable conduct in the straddle transactions. The truth is that it is the Commissioner, hiding behind the screen of the Statute of Limitations, who is seeking to collect an amount already paid to him, together with 16 years of interest on the amount mistakenly paid

---

[17](...continued)
lack authority to authorize the respondent to assess such excess. That is not to say, of course, that an adjustment to a prior year that, one, gives rise to a consequent adjustment in a year properly before this Court, and, two, will effect an overpayment or underpayment for such subsequent year similarly is barred. That is the case at hand, and the first clause of Section 6214(b) specifically contemplates such adjustments. 95 T.C. 437, 444. (Emphasis added).

Thus, it is apparent that the Tax Court is free to apply the doctrine of equitable recoupment in furtherance of its statutory duty to redetermine a deficiency for a year before it, and such application of the doctrine is consistent with Section 6214(b).

and unjustly retained.[18]

The Commissioner argues that the petitioners' inadvertent failure to file protective claims for refund for the tax in issue constituted a willful act of abuse which will deny them the remedy of equitable recoupment. Petitioners' inadvertent failure can no way be interpreted as an attempt to defraud the Government or take unfair advantage of the statute of limitations. To argue that equitable recoupment is unavailable to the petitioners because they failed to

---

[18] Is it not strange that Judge Nims, below, denied the petitioners' claim on the ground that the Tax Court had no equitable jurisdiction while in Glass v. Commissioner, 87 T.C. 1087 (1986), in Cook v. Commissioner, 90 T.C. 975 (1988) and in this case he held "that since the straddle transactions were a sham, gains reported by petitioners in year two and thereafter do not constitute taxable income to them ...". 87 T.C. 1087, 1177. Since it is a certainty that in the case of many of the taxpayers no gain years were before him (since there would have been no deficiencies in such years), was not Judge Nims, without appreciating it, doing equity to such Glass taxpayers to forestall the Commissioner from attempting to retain the taxes paid on their phantom gains?

keep the statute of limitations open is nonsensical, since equitable recoupment is available only to avoid the bar of the statute of limitations.[19]

---

[19] There is overwhelming authority for the rule that the taxpayer's failure to preserve the statute of limitations will not bar the remedy of equitable recoupment. In fact, as has been noted by commentators and the Courts, the statute of limitations had not expired in Bull prior to the assertion of the deficiency, and the taxpayer's apparent lack of diligence therein was not deemed a bar to recoupment. See Andrews, "Modern-Day Equitable Recoupment and the Two Tax Effect: avoidance of the Statutes of Limitations in Federal Tax Controversies:, 28 Arizona L. Rev. 595(1986) at 601 n. 27:

> ...It is also worthwhile to note that the executor in Bull might have been deemed somewhat lacking in diligence by not timely filing a claim for refund of federal estate tax when it first became known that the Commissioner would seek to subject the post-death partnership profits in hands of the estate to the income tax. Bull died on February 13, 1920 and, consequently, the estate tax provisions of the 1918 revenue act were implicated as it became law on February 24, 1919 and applied to persons dying after its passage. See Revenue Act of 1918, Pub. L. No. 254, ch. 18, §401, 40 Stat. 1057, 1906. The 1921 revenue act provided the applicable statute of limitation on making claims for refund. The taxpayer had to file the claim within a four year period measured from the date of payment. The 1921 act provided the applicable statute of limitations was to be given retroactive effect to claims for refund under, inter alia, the 1918 revenue act. Revenue Act of 1921, Pub. L. No. 98, ch. 136, §1316, 42 Stat. (part 1) 314.
>
> (continued...)

---

[19](...continued)
This four year period from the payment date for the filing of refund claims for estate tax was continued in both the 1924 and 1926 revenue acts. Revenue Act of 1924, Pub. L. No. 176, ch. 234 §1012, 43 Stat. (part 1) 342; Revenue Act of 1926, Pub. L. 20, ch. 27, §1112, 44 Stat. (pt. 2) 115. See Bull v. United States, 295 U.S. 247, 258 n. 7 (1935). The executor paid the federal estate tax on the post-death partnership profits in full in August 1921. Bull, 295 U.S. at 258 (1935). As the Commissioner notified the executor of the asserted income tax deficiency in July, 1925, the executor had up to one month in which to file an estate tax refund claim in timely fashion under the four-year-from-payment-date period. Despite the equitable nature of recoupment, the executor's seeming lack of diligence was not enough to prevent its application by the Supreme Court in Bull. This factor which bears upon the "equitableness" of equitable recoupment has not escaped the attention of the lower courts. See United States v. Bowcut, 287 F.2d 654, 656-657 (9th Cir. 1961); United States v. Herring, 240 F.2d 225, 228 (4th Cir. 1957).

Indeed, the Court in United States v. Bowcut, 287 F.2d 654, 656-57 (9th Cir. 1961), stated:

> The United States contends that for another reason recoupment should not be permitted under the circumstances of this case. It asserts that the situation from which relief is sought was created by the taxpayer's own lack of diligence in seeking refund of the estate tax. It is pointed out that the income tax deficiency was assessed on May 4, 1956, and that the statute did not run on estate tax refund until June 11, 1956, during all of which time the fact of overassessment of the estate tax had been known to the taxpayer. She then had five weeks within which to recover the overassessment of estate tax.
>
> (continued...)

The Commissioner also argues that, on procedural grounds, petitioners are not entitled to recoupment because it raises an impermissible new issue in the Rule 155 proceeding, and, on substantive grounds that the doctrine is inapplicable because the double taxation does not arise out of the same transaction. Suffice it to say that the Tax Court did not rule on these grounds and that

---

[19](...continued)
It is pointed out that in the Herring case there had been no opportunity at all to recover an estate tax refund and that such recovery could not have been had save through a recoupment against the income tax claim.

> The facts in the case before us are similar to those in Bull v. United States, and in our view that case is controlling upon this point. In that case the taxpayer had as much opportunity as had the taxpayer here to enforce a legal right to refund, and equitable relief was not denied for this reason. It is apparently not the diligence of the taxpayer as to his legal rights which controls, but rather the inequity of holding that, while the government's rights under a transaction continue unimpaired, its adversary's rights thereunder are barred by limitations. 287 F.2d at 657. (Emphasis added.)

neither has merit.[20,21]

---

[20] When it is kept in mind that the decision of the Tax Court was solely on the issue of the applicability of Section 108 as raised by motions for summary judgment, it will be appreciated that petitioners had no opportunity as they would have had upon a trial to tender these issues for consideration other than as abstract propositions. The facts upon which a determination must be made were thus presented in the Rule 155 proceeding by the petitioners, their first opportunity to do so. In intimating that petitioners were raising a new issue the Commissioner is clearly in error.

[21] In a commodities tax straddle a taxpayer closes the loss leg of the straddle in year one and the gain leg in year two, attempting to obtain a deferral of tax by shifting income from the first to the second year. A straddle, by definition, consists of two offsetting positions in property. See, *e.g.*, Internal Revenue Code Section 1092(c). Offsetting positions in commodities consist of a long and a short position. The balanced nature of these positions reduces economic risk, which is the *sine qua non* of a straddle. In Glass, Cook, and the present cases, the courts found the taxpayers trading in commodity tax straddles to lack economic substance. A transaction in any one leg alone does not constitute a straddle, let alone a tax-motivated commodities tax straddle, because it does not eliminate the market risk of the open leg while the offsetting unrecognized gain is being held for recognition in the succeeding year. Thus, it was tax straddles that were held to be without substance, not the mere closing of one leg or the other. The commodities tax straddle lacked economic substance because it was found to be prearranged. The technique required the subsequent closing of the gain leg as surely as it required the early closing of the loss leg. Thus, the commodities tax straddle, viewed as a single all-encompassing transaction for the purpose of determining economic substance, must similarly be so viewed for the purpose of determining whether the potential for unjust double taxation derives from a single transaction

(continued...)

B. EQUITABLE ESTOPPEL

Even if the Court were to decide that equitable recoupment (*i.e.*, the offset of taxes paid in respect of the phantom straddle gains in barred years against the deficiencies attributable to disallowed straddle losses of open years) is precluded, the petitioners should be allowed relief in the nature of equitable estoppel to offset the amounts of their commodity straddle net income against the amounts of their disallowed losses. (The net income attributable to such gain is the amount of the reported capital gain

---

[21](...continued)
for equitable recoupment purposes. See, Glass, at p. 1163, where the Court held that "the relevant transaction was petitioners' entire commodity tax straddle scheme" and again, at p. 1174: "We re-emphasize at this point, however, that the focus of our attention is petitioners' entire tax straddle scheme and not each separate straddle. It is the overall scheme which taints the deductibility of the year one losses."

included in gross income less the Section 1202 deduction of 60 percent of long-term capital gain. The net result is the amount of capital gain included in taxable income).

In the portion of its Supplemental Memorandum Opinion captioned "Equitable Recoupment Issue" the Tax Court addressed petitioners' position concerning equitable recoupment. The petitioners also contended, in the alternative, that the Commissioner be equitably estopped from disallowing losses to the extent of taxable income attributable to straddle gains reported in barred years, as defined above, but the Tax Court completely ignored this argument.

The grant of relief in the nature of equitable estoppel as claimed herein merely requires that the Tax Court determine the fact that an amount of income was included in subsequent years

attributable to commodities transactions and that it would be inequitable to find a deficiency which took no note of such erroneous inclusion of income when correction in the year of inclusion was barred by the statute of limitations. There is no reason nor need to determine the amount of tax paid attributable to those gains, let alone whether or not the taxpayers underpaid or overpaid their liability in those years. No issue arises under Section 6214(b) in this connection, any more than a Section 6214(b) issue arises from the recomputation of a net operating loss of a prior or subsequent year as a necessary ingredient of a redetermination of a deficiency for year before the Court.

The doctrine merely requires that the Commissioner, with knowledge that the tax has already been paid on the phantom gains of a barred year, should be

precluded from seeking to impose the tax a second time via the route of disallowing the fictitious losses of the open years.

The effect of such equitable estoppel, and all facts necessary for its determination were contained in the Petitioners' Alternative Computations for Entry of Decision and Alternative Schedules which were submitted to the Tax Court pursuant to Rule 155.

The petitioners' position derives explicit support from Herrington v. Commissioner, 854 F.2d 755 (5th Cir. 1988).[22] In Herrington, a Glass[23] petitioner, properly before the Court for a year in which he incurred both straddle gains and losses, sought to have the

---

[22] Herrington was followed by the Court of Appeals for the Seventh Circuit in Kielmar v. Commissioner, 884 F.2d 959, 965 (7th Cir. 1989).

[23] Glass v. Commissioner, 87 T.C. 1087 (1986), is the seminal tax straddle case.

gains reversed on the authority of the Court's opinion in Glass that straddle losses and gains not be recognized. The gains corresponded to straddle losses reported in an earlier year for which adjustment was foreclosed by the statute of limitations.

The Tax Court and the Fifth Circuit both held, in effect, that the Herringtons were estopped from denying that the gains had been realized by them where the Commissioner was precluded from adjusting the loss year. In order to prevent unfairness this decision gave recognition to the "gains" in the face of the Tax Court's holdings in Glass, *supra,* and Fox, *supra,* the instant case, that gains on tax straddles are not entitled to recognition.

Why was the Commissioner in Herrington allowed to overcome the adverse impact of the bar of the statute,

but not the appellants herein? Application of the doctrine of equitable estoppel in the manner herein described is consistent with Glass, Fox, Herrington, and Estate of Smith v.Commissioner, 94 T.C. 872 (1990), wherein the Tax Court made an equitable adjustment to ameliorate the effect of its revaluation (for estate tax purposes) of a gift made in a closed year. Further, the doctrine is consistent with Section 6214(b), makes both parties whole, and prevents the unjust enrichment of the Commissioner. It is neither the Commissioner's, nor the Tax Court's function to protect the revenue by exploiting the statute of limitations to obtain an unfair result. The purpose of the statute is merely to bar stale claims, and the claims herein, although relating to a closed year, cannot be considered as stale when they correspond

to the very transactions which generated the losses at issue. As indicated in Woods v. Commissioner, 92 T.C. 776, at 784, 785 the Tax Court certainly has authority to employ equitable principles, including estoppel, where the circumstances warrant. These are such circumstances.

CONCLUSION

For the foregoing reasons petitioners respectfully request this Court direct a Writ of Certiorari to the Court of Appeals to review and determine the issues raised herein in order to prevent the unjust enrichment of the Government based upon an unsupportable interpretation of the Tax Court's jurisdiction which deprives taxpayers of substantive rights.

Respectfully Submitted,

Elias Rosenzweig
Stanley Klein
Michael Weitzner

BRAUNER BARON ROSENZWEIG & KLEIN
61 Broadway - 18th Floor
New York, NY 10006
(212) 797-9100

Dated: February 20, 1992

APPENDIX

TABLE OF CONTENTS

	Page
Opinion of the United States Court of Appeals for the Second Circuit in *Gardner v. CIR*, Filed January 22, 1992	A-1
Tax Court Supplemental Memorandum Opinion in *Kazi v. Commissioner of Internal Revenue*	A-9
Tax Court Memorandum Opinion in *Fox v. Commissioner of Internal Revenue*	A-26
Decision of the United States Tax Court in *Falk v. Commissioner of Internal Revenue*	A-43
Decision of the United States Tax Court in *Gardner v. Commissioner of Internal Revenue*	A-44
Stipulation of Facts	A-46
Section 108, Tax Reform Act of 1984, as Amended	A-62
Judgment Order of the United States Court of Appeals for the Third Circuit in *Massey v. CIR*, Dated November 22, 1991	A-65
Opinion of the United States Court of Appeals for the Third Circuit in *Lerman v. CIR*, Filed July 17, 1991	A-68

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 738, 739, 597, 598, 740, 599, 741, 600, 742, 601, 743, 602, 744, 603, 745, 604, 746, 605, 747, 748, 606, 749, 607, 608, 750, 609, 751, 752, 610, 611, 753, 612, 754, 613, 755, 614, 756, 615, 616, 757, 617, 758, 618, 759, 619, 620, 760—August Term 1991

(Argued January 10, 1992 Decided January 22, 1992)

Docket Nos. 90-4140(L), -4141, -4142, -4143, -4144, -4146, -4148, -4150, -4152, -4154, -4156, -4158, -4160, -4162, -4164, -4166, -4168, -4170, -4172, -4174, -4176, -4178, -4180, -4182, -4186, -4188, 91-4026, -4038, -4054, -4056, -4068, -4070, -4072, -4074, -4076, -4078, -4080, -4082, -4086, -4088, -4090, -4092, -4094, -4096, -4098, -4100, -4118

HILARY P. GARDNER; JUDITH C. GARDNER; REED CLARK; AUDREY CLARK; DOMINICK A. CADEMARTORI; JEAN E. CADEMARTORI; RALPH G. KAZI; JEAN KAZI; CHARLES H. FALK; JOAN FALK; ARTURO STERLING; LYDIA STERLING; DANIEL GUTMAN; and JUDITH GUTMAN,

Petitioners-Appellants-Cross-Appellees,

TERENCE J. HORN and JEAN HORN,

Petitioners-Appellants,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee-Cross-Appellant.

Before:

ALTIMARI, MAHONEY, and WALKER,
Circuit Judges.

Taxpayers appeal from a decision of the tax court (Arthur A. Nims, III, Chief Judge) upholding the Commissioner's assessment of deficiencies and denial of deductions for losses taken by closing out loss legs of commodity future straddles.

Affirmed.

ELIAS ROSENZWEIG (Stanley Klein, Michael Weitzner, Brauner, Baron, Rosenzweig, Kligler, Sparber, Bauman & Klein, New York, NY of counsel) *for Appellants.*

SHIRLEY D. PETERSON, Assistant Attorney General, Washington, D.C. (Gary R. Allen, Kenneth L. Green, Kimberly S. Stanley, Attorneys, Tax Division, Department of Justice, Washington, D.C. of counsel) *for Appellees.*

PER CURIAM:

This case is part of the second wave of "straddle" cases to come before the federal courts. In the first wave, purchasers of commodity straddles challenged the Commissioner of Internal Revenue's denial of loss deductions taken pursuant to closing out the loss legs of their straddles. The Tax Court, in the landmark case of *Glass v. Commissioner*, 87 T.C. 1087 (1986), determined that the straddles were sham transactions that lacked economic substance. Accordingly, the Tax Court upheld the Commissioner's denial of these deductions. On appeal, the *Glass* decision has been affirmed in nine of our sister circuits. *Dewees v. Commissioner*, 870 F.2d 21 (1st Cir. 1989); *Friedman v. Commissioner*, 869 F.2d 785 (4th Cir. 1989); *Killingsworth v. Commissioner*, 864 F.2d 1214 (5th Cir. 1989); *Ratliff v. Commissioner*, 865 F.2d 97 (6th Cir. 1989); *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988); *Lee v. Commissioner*, 897 F.2d 915 (8th Cir. 1989); *Keane v. Commissioner*, 865 F.2d 1088 (9th Cir. 1989); *Bohrer v. Commissioner*, 945 F.2d 344 (10th Cir. 1991); *Kirchman v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989). We can only hope that the first wave of challenges has at last broken.

Despite this impressive record of failure, the purchasers of straddles have not given up. Courts are now faced with the second wave of challenges, this time brought by a particular purchaser subgroup, namely commodities dealers or brokers who purchased straddles for their own account. These brokers assert that, in contrast to their customers, they are entitled to take loss deductions derived from straddle transactions. As authority for this startling proposition, the taxpayers point to § 108(b) of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 108(b), 98 Stat. 494, 630 *as amended by* the Tax Reform Act of

1986, Pub.L. No. 99-514, § 1808(d)(2), (4), 100 Stat. 2085, 2817-18, *reprinted at* I.R.C. (26 U.S.C.) § 1092 note (1988) (hereinafter § 108(b)), which provides that "[f]or purposes of subsection (a), [which covers pre-1982 straddle transactions], any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business." This theory was first put forth and rejected in *Cook v. Commissioner*, 90 T.C. 975 (1988), *aff'd*, 941 F.2d 734 (9th Cir.), cert. denied 112 S. Ct. 172 (1991).

Undeterred by *Cook* and *Glass*, the petitioners here, associates of Czarnikow-Rionda Company, Inc., Czarnikow-Rionda Trading Company, Inc., and/or Rionda de Pass Ltd, (and their spouses) assert that their status as commodities brokers entitled them to take deductions for the loss legs of commodities straddles they entered into on the London Metals Exchange. The petitioners stipulated that their transactions were the same as those found to be shams in *Glass* and affirmed as such by every court to consider them.

The Tax Court rejected petitioner's claim. *Fox v. Commissioner*, 55 T.C.M. (CCH) 863 (1988). Citing our decision in *DeMartino v. Commissioner*, 862 F.2d 400 (2d Cir. 1988), the Tax Court concluded that Congress did not intend the section 108(b) presumption to apply to transactions that were "prearranged or shams in substance." *Fox*, 55 T.C.M. (CCH) at 869. Since the taxpayers had stipulated that their transactions were similar to the transactions in *Glass*, the *Fox* court concluded that the transactions at issue were shams. *Id.* at 868. Accordingly, the court affirmed the Commissioner's denial of the deduction.

After issuing its opinion in *Fox*, the Tax Court withheld entry of judgment in order to allow the parties to submit computations under Tax Court Rule 155. In the rule 155 proceeding, petitioners raised a host of equitable and legal claims in an effort to win back some of the deductions denied by the court in its main decision. In *Kazi v. Commissioner*, 61 T.C.M. (CCH) 1759 (1991), the Tax Court rejected these claims as being either outside the scope of the Rule 155 proceeding, outside the jurisdiction of the Tax Court, or unsupported by law. Petitioners appeal from the decisions in *Fox* and *Kazi*.

Since appeals from the Tax Court are taken to the circuit in which the taxpayer resides, I.R.C. § 7482(b)(1)(A), the *Fox* and *Kazi* decisions were presented for review simultaneously in the Second, Third, and District of Columbia Circuits. The Third Circuit, in a thorough and well-reasoned opinion, affirmed the Tax Court in all respects. *Lerman v. Commissioner*, 939 F.2d 44 (3d Cir.), *cert. denied*, 112 S. Ct. 590 (1991). We agree with the Third Circuit and therefore affirm as well.

Background

The basic structure of the commodities future straddle has been explained quite carefully elsewhere. *See Dewees v. Commissioner*, 870 F.2d 21 (1st Cir. 1989). For the purposes of this opinion, it suffices to say that the straddles at issue here were structured so as to insure an ordinary loss in the first year and a corresponding capital gain in the second year. The loss in the first year could be used to offset ordinary income while the gain in the second year would be taxed at the lower, capital gains rate. In effect, the straddle allowed the taxpayer both to get an interest

free loan from the government and to reap the difference between tax rates for ordinary income and capital gains.

Because straddles represented a nearly foolproof way to defer taxes, Congress in 1984 enacted section 108. § 108(a) [as amended in 1986] provides that

> in the case of any disposition of 1 or more positions . . . [which] form part of a straddle . . . any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a trade or business, or . . . in a transaction entered into for profit.

In other words, straddle losses are deductible only when derived from a profit motivated straddle transaction, rather than from a tax motivated transaction. In the 1986 amendments to Section 108, Congress added section 108(b), which provides an irrebuttable profit motive presumption to straddle transactions entered into by commodities brokers. Petitioners here assert that this irrebuttable presumption legitimates their straddle losses, notwithstanding their concession in the Tax Court that the transactions were shams, entered into solely for tax purposes, that lacked economic substance.

Discussion

Since *Gregory v. Helvering*, 293 U.S. 465 (1935), it has been settled law that "for transactions to be recognized for tax purposes they must have economic substance." *Lerman*, 939 F.2d at 52. Petitioners contend that Congress overturned this long applicable norm of tax law when it enacted section 108(b). They argue that Congress intended that commodities brokers be allowed to recognize losses suffered in straddle transactions, even when

those transactions lacked any economic substance. Petitioners boldly assert that Congress intended to present commodities brokers with a special favor, in effect a cash grant, and that the Tax Court improperly denied them their bounty.

Petitioners' argument, though not wholly implausible, is foreclosed by our decision in *DeMartino v. Commissioner*, 862 F.2d 400 (1988). There we rejected a similar claim brought by a broker in crude oil futures. We noted that as a general rule "a statute should not be interpreted to produce an absurd or unreasonable result," *id.* at 407, like giving tax consequences to a sham transaction. We saw no reason to depart from that general rule, since the petitioner's argument was inconsistent with the plain language of the statute. Specifically, we stated that "the taxpayer's argument ignores the opening clause of section 108(b), '[f]or purposes of subsection (a),' which makes the presumption of section 108(b) applicable only when section 108(a) applies to the transaction. Section 108(a) does not apply to straddle transactions that are shams." *Id.* Accordingly, we concluded that the section 108(b) presumption did not apply and upheld the disallowance of the loss.

Petitioners attempt to distinguish *DeMartino* on the ground that the transactions in *DeMartino* were "prearranged, contrived transactions conducted in a market rigged to produce tax losses." *DeMartino*, 862 F.2d at 406. In contrast, petitioners assert that the transactions at issue here were real transactions, albeit ones that lacked economic substance.

We do not think the holding of *DeMartino* is limited to "contrived transactions" in a "rigged market". *DeMartino* defined sham transactions to include transactions that are

"fictitious or . . . [lacking] business purpose or economic effect other than the creation of tax deductions." *Id.* In their stipulation, the taxpayers effectively concede that their transactions meet the *DeMartino* definition of a sham. Accordingly, *DeMartino*'s conclusion that section 108(b) does not apply in these circumstances is binding.

Even were we not bound by *DeMartino*, we would agree with the Third Circuit that "[t]here is no sound reason to conclude that, in enacting the amendments to section 108(b), Congress meant to abandon the [economic substance] doctrine." *Lerman*, 939 F.2d at 54. Instead, we think "the much more logical conclusion is that . . . section 108 eliminated the profit motive inquiry in cases involving dealers because of the inherent difficulty in making such an inquiry, but it did not prevent inquiry into the economic substance of a dealer's commodities transactions." *Id.* at 55. Since the taxpayers concede that their straddle transactions lacked economic substance, and since it is well established that a subjective profit motive can not save a transaction that objectively lacks economic substance, *see Knetsch v. United States*, 364 U.S. 361, 365 (1960); *Lerman*, 939 F.2d at 55; *Forseth v. Commissioner*, 845 F.2d 746, 748 (7th Cir. 1988), we agree with the Tax Court and the Third Circuit that the straddle transactions did not create any recognizable losses.

Conclusion

We have considered the remainder of petitioners' arguments and find them to be without merit. Further, we agree with the Tax Court's disposition of petitioners' Rule 155 motions. Accordingly, we affirm the decision of the Tax Court in all respects.

Affirmed.

RALPH G. KAZI AND JEAN KAZI, ET AL., Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent Cases of the following petitioners have been consolidated herewith: Daniel Gutman and Judith Gutman, docket No. 10234-79; Terence J. Horn and Jean Horn, docket Nos. 10236-79 and 16675-83; Arturo Sterling, docket No. 10237-79; Hilary P. Gardner and Judith C. Gardner, docket No. 10238-79; Reed Clark and Audrey I. Clark, docket Nos. 10240-79 and 23479-81; Dwight B. Massey and Joann V. Massey, docket Nos. 10241-79 and 22297-80; Charles H. Falk and Joan A. Falk, docket No. 10242-79; Joseph L. Fraites and Evelyn S. Fraites, docket Nos. 10243-79 and 23476-81; Dominick Cademartori and Jean E. Cademartori, docket No. 10244-79; Charles S. Lerman and Barbara Lerman, docket No. 13246-80.

Docket Nos. 10233-79, 10234-79, 10236-79, 10237-79, 10238-79, 10240-79, 10241-79, 10242-79, 10243-79, 10244-79, 13246-80, 22297-80, 23476-81, 23479-81, 16675-83

UNITED STATES TAX COURT

T.C. Memo 1991-37; 1991 Tax Ct. Memo LEXIS 48; 61 T.C.M.(CCH) 1759

January 30, 1991, Filed

NIMS, Chief Judge.

SUPPLEMENTAL MEMORANDUM OPINION

On December 15, 1988, the Court filed its opinion in this case, Fox v. Commissioner, T.C. Memo. 1988-570, but withheld entry of decision to enable the parties to submit computations in accordance with Rule 155. (All Rule references are to the Tax Court Rules of Practice and Procedure. Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue.) By order dated December 27, 1989, the docketed cases of Jack M. Fox and Marliss S. Fox (docket Nos. 3453-79, 10069-79 and 21879-80) were severed from the group of these consolidated cases and thereafter this case has proceeded under the caption Ralph G. Kazi and Jean Kazi, et al. v. Commissioner, docket Nos. 10233-79, et al.

In Fox, the parties filed cross-motions for summary judgment pursuant to Rule 121 along with supporting briefs. In their motions, the parties agreed that the sole issue for decision was whether the per se profit motive rule of section 108(b) of the Tax Reform Act of 1984 (Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630), as amended by section 1808(d) of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2817), applies to protect dealers from a finding that their straddle transactions were shams devoid of economic substance. (Section 108 of the Tax Reform Act of 1984 is subsequently herein referred to as section 108.) In Fox v. Commissioner, supra, we held that:

> as a matter of law that petitioners' straddle transactions produced no losses to which the per se rule of section 108(b) can be applied.* * * Likewise, since the straddle

> transactions were shams, gains reported by petitioners in the latter years do not constitute taxable income to them. [56 T.C.M. 863, 869, 57 P-H Memo T.C. par. 88,570, at 2951.]

We withheld entry of decision in these cases for the purpose of permitting the parties to submit computations pursuant to our determination of the per se profit motive issue. Rule 155(a).

On March 29, 1990, respondent filed his computations for entry of decision under Rule 155. On July 20, 1990, petitioners filed their objections to respondent's computations, together with their alternative computations and a memorandum of law in support of their objections and alternative computations. In their objections, petitioners agreed with respondent's computations in the following docketed cases: 10239-79, 13247-80, 13248-80, 22240-80, 22291-80, 22292-80, 22293-80, 22294-80, 22295-80,

22296-80, 23477-81, 23614-81, 31359-81, 974-82, 13919-82 and 13920-82. Consequently, by order dated July 26, 1990, these docketed cases were severed from this case.

On August 27, 1990, respondent filed: (1) a response to petitioners' objections and alternative computations and a memorandum of law in support thereof; and (2) revised computations for entry of decision in docket Nos.10233-79, 10237-79, 10241-79, 10243-79, 10244-79 and 22297-80 to reflect certain concessions with regard to some of petitioners' objections. In their objections, petitioners asserted that respondent made various computational errors in docket Nos. 10233-79, 10237-79, 10241-79, 10243-79, 10244-79 and 22297-80. Respondent has conceded these errors.

The parties' computations reflect disagreement over whether petitioners are entitled to a deduction for their out-of-pocket expenses related to their investment in the straddle transactions involved herein (out-of-pocket expense issue). The parties' computations also reflect disagreement over whether the amount of any deficiency attributable to a straddle transaction loss may be reduced by the amount of any: (1) tax paid on the corresponding straddle gain reported in a subsequent taxable year not barred by the statute of limitations (offsetting gain issue); (2) tax paid on the corresponding straddle gain reported in a subsequent taxable year barred by the statute of limitations under the doctrine of equitable recoupment or estoppel (equitable recoupment issue); and (3) alleged overpayment arising in a year not before us and unrelated to the

issues in this case (unrelated overpayment issue).

Out-of-Pocket Expense Issue

Petitioners in docket Nos. 23476-81, 23479-81 and 16675-83 assert that they are entitled to a deduction for their out-of-pocket expenses related to their investment in the straddle transactions pursuant to section 108(c). Respondent contends that the deductibility of out-of-pocket expenses is a new issue which may not be raised for the first time in a Rule 155 proceeding, citing Rule 155(c).

Rule 155 is the mechanism through which the Court enters a decision for the amount of deficiency or overpayment resulting from the disposition of the issues involved in a case. Harwood v. Commissioner, 83 T.C. 692, 694 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986); Cloes v.

Commissioner, 79 T.C. 933, 935 (1982). Computations under Rule 155 are to be determined solely in accordance with the Court's findings and conclusions and are generally "purely mathematical adjustments." See The Home Group, Inc. v. Commissioner, 91 T.C. 265, 269 (1988), affd. 875 F.2d 377 (2d Cir. 1989); Rule 155(a) and (b).

Rule 155(c) provides as follows:

> (c) Limit on Argument: Any argument under this Rule will be confined strictly to consideration of the correct computation of the deficiency, liability, or overpayment resulting from the findings and conclusions made by the Court, *and no argument will be heard upon or consideration given to the issues or matters disposed of by the Court's findings and conclusions or to any new issues. This Rule is not to be regarded as affording an opportunity for retrial or reconsideration.* [Emphasis added.]

Thus, any argument made in a Rule 155 proceeding must be strictly confined to

the correct computation of the deficiency, liability or overpayment resulting from the findings of fact and conclusions made in our opinion. No argument may be made in a Rule 155 proceeding which raises a new issue. See Bankers Pocahontas Coal Co. v. Burnet, 287 U.S. 308 (1932); Cloes v. Commissioner, supra.

Petitioners could have raised the issue of whether they were entitled to a deduction for their out-of-pocket expenses in the summary judgment proceeding where the transactions in question were considered on the merits. See Rule 31(c). In their motions for summary judgment, however, petitioners agreed that all other issues have been resolved and that the sole issue for decision was whether the per se profit motive rule under section 108(b) applied in this case. Thus, petitioners did not

there raise the issue of whether their out-of-pocket expenses were deductible under section 108(c).

It is the policy of this Court to adjudicate all issues raised in a case in one proceeding to avoid piecemeal and protracted litigation. Robin Haft Trust v. Commissioner, 62 T.C. 145, 147 (1974), affd. on this issue, vacated and remanded 510 F.2d 43, 45 n.1 (1st Cir. 1975). As a predicate to the allowance of any deduction for out-of-pocket expenses, an evidentiary hearing, or the submission of agreed facts, would be necessary. A Rule 155 proceeding is not appropriate for this purpose. Accordingly, we decline to consider the new issue which petitioners are now attempting to raise.

Offsetting Gain Issue

Petitioners in all docket Nos. assert that the amount of any deficiency attributable to a straddle loss should be

reduced by the amount of any tax paid on the corresponding straddle gain reported in a subsequent year. Respondent contends that any tax paid on a fictitious straddle gain reduces the amount of any deficiency or increases the amount of any overpayment in the year the gain was reported.

Petitioners first assert that the gain and loss legs from the straddle transactions must be closed out in the same year the transaction arose, the loss year, because "A transaction which is a nullity from inception cannot be divided into components and given partial effect in different tax years." Aside from the fact that this also is a new issue, petitioners do not cite any authority for this assertion. Petitioners reported the loss and gain legs of the sham straddle transactions in different taxable years. Therefore, the gain and loss legs of the

sham straddle transactions should be eliminated in the year each gain or loss was reported.

Petitioners next assert that the gain and loss legs from their straddle transactions must be closed out in the same year the transaction arose, the loss year, because "merely reversing the reported gain does not adequately implement the Court's relevant findings." Petitioners do not point to any part of our opinion in Fox v. Commissioner, supra, which supports their position. Our holding in Fox that the straddle transactions were shams in substance does not imply that the loss reported in one year must be offset by the corresponding gain reported in a subsequent year. Therefore, the elimination of the gain and loss legs in the year each gain or loss was reported gives full effect to

our holding that the straddle transactions were shams.

Equitable Recoupment Issue

Petitioners in docket Nos. 10238-79, 10242-79 and 13246-80 assert that the amount of any deficiency attributable to a straddle loss should be reduced by the amount of tax paid on the corresponding straddle gain in a subsequent taxable year barred by the statute of limitations under the doctrine of equitable recoupment or equitable estoppel. Respondent contends that this Court may not grant the equitable relief requested by petitioners because to do so would expand this Court's jurisdiction beyond that permitted by statute.

It is well established that as a court of limited jurisdiction we cannot expand our jurisdiction by granting equitable relief. Woods v. Commissioner, 92 T.C. 776, 787 (1989); Phillips

Petroleum Co. v. Commissioner, 92 T.C., 885, 889-890 (1989); Knapp v. Commissioner, 90 T.C. 430, 440 (1988), affd. 867 F.2d 749 (2d Cir. 1989). Accordingly, we hold that the amount of any deficiency attributable to a straddle loss may not be reduced by the amount of tax paid on corresponding fictitious straddle gains arising in years barred by the statute of limitations because this Court does not have equitable recoupment jurisdiction.

Unrelated Overpayment Issue

Petitioners in docket Nos. 10237-79, 10238-79 and 10242-79 assert that the amount of any deficiency attributable to a straddle loss should be reduced by the amount of an alleged unrelated overpayment of tax made in 1974, a year not before the Court. Respondent contends that this Court does not have

jurisdiction to determine an overpayment in a year not before the Court.

Section 6213(a) generally authorizes this Court to redetermine respondent's deficiency determinations provided that a timely petition is filed. Section 6214(b) further provides that:

> (b) JURISDICTION OVER OTHER YEARS * * * -- The Tax Court in redetermining a deficiency of income tax for any taxable year * * * shall consider such facts with relation to the taxes for other years * * * as may be necessary correctly to redetermine the amount of such deficiency, *but in so doing shall have no jurisdiction to determine whether or not the tax for any other year * * * has been overpaid or underpaid.* [Emphasis added.]

In sum, this Court may consider facts in other taxable years as needed to correctly redetermine a deficiency for a given year. This Court does not, however, have jurisdiction to determine whether petitioners have overpaid or underpaid their taxes in other years not

before the Court. See Secs. 6211(a); 6214(b); 6512(b); Commissioner v. Gooch Milling & Elevator Co., 320 U.S. 418 (1943); First Security Bank of Idaho, N.A. v. Commissioner, 592 F.2d 1046 (9th Cir. 1979); Phillips Petroleum Co. v. Commissioner, supra.

Accordingly, we hold that the amount of any deficiency for the years in issue is not reduced by the amount of any alleged unrelated overpayment of tax arising in 1974, a year not before the Court.

To reflect the foregoing,

Decisions will be entered in accordance with respondent's computations in docket Nos. 10234-79, 10236-79, 10238-79, 10240-79, 10242-79, 13246-80, 23476-81, 23479-81 and 16675-83.

Decisions will be entered in accordance with respondent's revised computations in docket Nos. 10233-79,

10237-79, 10241-79, 10243-79, 10244-79 and 22297-80.

JACK M. FOX AND MARLISS S. FOX, ET AL., Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent[1]

Docket Nos. 3453-79; 10069-79; 10233-79; 10234-79; 10236-79; 10237-79; 10238-79; 10239-79; 10240-79; 10241-79; 10242-79; 10243-79; 10244-79; 13246-80; 13247-80; 13248-80; 21879-80; 22240-80; 22291-80; 22292-80; 22293-80; 22294-80; 22295-80; 22296-80; 22297-80; 23476-81; 23477-81; 23478-81; 23479-81; 23480-81; 23614-81; 31359-81; 974-82; 13919-82; 13920-82; 16675-83; 21394-83.

COUNSEL: Samuel Brodsky, for the petitioners in docket Nos. 3453-79, 10069-79 and 21879-80.

Elias Rosenzweig, Stanley Klein and Michael J. Weitzner, for the petitioners in all other dockets.

Victoria Wilson Fernandez and George H. Soba, for the respondent.

NIMS, Chief Judge: This case is before the Court on petitioners' motion for summary judgment and respondent's cross-motion for summary judgment filed pursuant to Rule 121, Tax Court Rules of Practice and Procedure, on May 1, 1987, and June 3, 1987, respectively.

---

[1] Cases of the following petitioners are consolidated herewith: Reed Clark and Audrey I. Clark, docket Nos. 10240-79, 22291-80 and 23479-81; Ralph G. and Jean Kazi, docket Nos. 10233-79, 22296-80 and 23478-81; Jack M. Fox and Marliss S. Fox, docket Nos. 10069-79 and 21879-80; Terence J. Horn and Jean Horn, docket Nos. 10236-79, 13248-80 and 16675-83; Dwight B. Massey and Joann V. Massey, docket Nos. 10241-79, 22297-80 and 23614-81; Joseph L. Fraites and Evelyn S. Fraites, docket Nos. 10243-79, 22295-80 and 23476-81; Dominick A. Cademartori and Jean E. Cademartori, docket Nos. 10244-79, 22293-80, 23480-81 and 21394-83; Daniel Gutman and Judith Gutman, docket Nos. 10234-79 and 13247-80; Hilary P. Gardner and Judith C. Gardner, docket Nos. 10238-79, 22240-80 and 31359-81; Charles H. Falk and Joan A. Falk, docket Nos. 10242-79, 22292-80, 974-82 and 13920-82; Charles S. Lerman and Barbara Lerman, docket Nos. 10239-79 and 13246-80; Arturo Sterling, docket No. 10237-79; Arturo Sterling and Lydia Sterling, docket Nos. 22294-80, 23477-81 and 13919-82.

Respondent determined the following deficiencies in and additions to petitioners' Federal income taxes:

Docket No.	Year	Deficiency	Addition to Tax Sec. 6653(a)
3453-79	1974	87,809.00	-
10069-79	1975	239,511.00	-
10233-79	1975	501,133.00	-
10234-79	1975	104,034.00	-
10236-79	1975	88,429.00	-
10237-79	1975	1,339,103.00	-
10238-79	1975	515,853.00	-
10239-79	1975	155,041.00	-
10240-79	1975	1,874,215.00	-
10241-79	1975	672,734.00	-
10242-79	1975	689,265.00	-
10243-79	1975	1,654,083.00	-
10244-79	1975	191,566.00	-
13246-80	1976	258,416.00	12,921.00
13247-80	1976	79,839.00	3,992.00
13248-80	1976	16,832.00	842.00
21879-80	1976	459,735.00	-
22240-80	1976	720,918.00	-
22291-80	1976	2,684,599.00	-
22292-80	1976	982,189.00	-
22293-80	1976	205,152.00	-
22294-80	1976	871,515.00	-
22295-80	1976	2,062,269.00	-
22296-80	1976	664,905.00	-
22297-80	1976	616,521.00	-
23476-81	1977	6,211,615.00	-
23477-81	1977	532,023.00	-
23478-81	1977	2,279,247.00	-
23479-81	1977	8,251,560.00	-
23480-81	1977	364,896.00	-
23614-81	1977	4,384,235.00	-
31359-81	1977	301,742.50	-
974-82	1977	724,640.58	-

13919-82	1978	195,019.00	-
13920-82	1978	161,366.00	-
16675-83	1977	82,626.00	-
	1978	39,613.00	-
	1979	5,313.00	-
21394-83	1978	87,606.00	-
	1979	205,160.00	-
	1980	74,953.00	-

After concessions,[2] the sole issue for decision is whether the per se profit motivation rule section 108(b)[3] of the Tax Reform Act of 1984 (Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630), as amended by section 1808(d) of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2817) (hereinafter section 108), applies to protect dealers from a finding that their straddle transactions are shams devoid of economic substance.

BACKGROUND

At the time their petitions were filed, the States of residence of the respective petitioners were as follows:

Name	States of Residence
Reed and Audrey I. Clark	New York
Ralph and Jean Kazi	New York
Jack M. and Marliss S. Fox	Hawaii
Terence J. and Jean Horn	New York
Dwight B. and Joann V. Massey	New Jersey

---

[2] Three cases, docket Nos. 23478-81, 23480-81 and 21394-83 also involve unrelated issues. "Piggyback" agreements have been entered into regarding these issues so that we need not consider them at this time. All other adjustments have been resolved.

[3] See Appendix A for text of section 108 of Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630, as amended by section 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514. 100 Stat. 2085, 2817.

Joseph L. and Evelyn Fraites	New Jersey
Dominick and Jean Cademartori	New York
Daniel and Judith Gutman	New York
Hilary and Judith Gardner	New York
Charles and Joan Falk	New York
Charles and Barbara Lerman	New Jersey
Arturo Sterling	New York

All of the petitioner-wives are parties to these proceedings only by virtue of their filing joint returns with petitioner-husbands. All of the petitioner-husbands (hereinafter petitioners) were associated with Czarnikow-Rionda Company, Inc., a subchapter S corporation, Czarnikow-Rionda Trading Company, Inc. or Rionda de Pass Ltd. (hereinafter referred to collectively as "Rionda"). During the years in issue, Rionda was a member of the New York Coffee and Sugar Exchange (Exchange). The Exchange is now known as the New York Coffee, Sugar and Cocoa Exchange. The Exchange has been designated as a contract market by the Commodity Futures Trading Commission (CFTC) and Rionda was registered as a futures commission merchant with the CFTC.

During the years at issue, Rionda regularly traded in physical sugar, sugar futures and options on sugar futures for its own account. It also acted as a broker in the purchase and sale of sugar futures and options on sugar futures. These transactions took place on the Exchange as well as on foreign exchanges.

Various petitioners were shareholders or officers of Rionda. Each petitioner was registered with the CFTC as an employee of Rionda. Petitioners Clark, Fraites, Falk and Massey were members of the Exchange during the years in issue, although Exchange rules may have limited full exercise of their membership privileges. Petitioner Gardner became a member of the Exchange in April, 1976.

At all times during the years in issue, Rionda maintained substantial positions in physical sugar and in sugar futures contracts on the Exchange. On a daily basis it purchased and sold

sugar future contracts on the Exchange. Petitioners Clark, Fraites, Massey, Falk, Gardner, Sterling, Gutman, Horn, Lerman and Kazi participated in the decision-making processes of Rionda's business and executed futures trades on a directed or discretionary basis for customers of Rionda.

The issue for decision did not, however, arise from petitioners' option trading activities on behalf of Rionda. Rather, the issue before us concerns the consequences of various silver and tin option and future straddles which petitioners transacted on the London Metal Exchange (LME). Petitioners traded silver options and futures through Lonconex and tin option and futures through Bear Stearns on the LME. Petitioners' straddle transactions were designed to produce ordinary losses in the initial year and short-term capital gains in the subsequent years. The short-term capital gains would then be converted into long-term capital gains through executing new futures straddles in silver, copper and other commodities on other domestic or foreign exchanges.

Petitioners have stipulated that the London options transactions at issue in this case are of the same type as those described by the Court in "Section III A" of its Findings of Fact in *Glass v. Commissioner*, 87 T.C. 1087, 1104-1106 (1986), affd. sub nom. *Herrington v. Commissioner*, 854 F.2d 755 (5th Cir. 1988), affd. sub nom. *Yosha v. Commissioner*, F.2d (7th Cir., Nov. 8, 1988):

> III. The London Options Transactions
>
> A. In General
>
> We turn now to a description of the actual transactions at issue in these consolidated cases. As previously noted, a typical London options transaction took place over a 2-year period in the form of either an option straddle or an option hedge. An option-straddle transaction,[11] the more prevalent

[11] The term "option-straddle transaction" as used herein denotes a type of trading strategy based upon the use of both options and futures contracts. The term is to be distinguished from the term "option straddle" which is simply a straddle consisting of option contracts.

trading strategy, was initiated by the following combination of trades in the first year of the transaction:

(1) An option straddle was put on, consisting of the simultaneous purchase and sale (grant) of either a call or put option (or both), for identical quantities of the same commodity with different delivery dates; and

(2) A futures straddle was also put on, consisting of the simultaneous purchase and sale of futures contracts for identical quantities of the same commodity with different delivery dates.

Shortly after the option straddle was put on, the legs would be closed out through the purchase and sale of identical offsetting positions. The premium (purchase price) paid to buy an offsetting option which closed out the sold (granted) option would exceed the premium that had been received on the granted option, resulting in an overall net loss on the sold option leg of the straddle. Conversely, the premium received on the sale of an offsetting option which closed out the purchased option would exceed the premium that had been paid for the purchased option, resulting in an overall net gain on the purchased option leg of the straddle. The net loss and gain, which were approximately equal, would be reported as an ordinary loss and short-term capital gain for the first year of the transaction. Since the expected tax result in the first year was generally an ordinary loss, such loss could be used to offset ordinary income from unrelated sources.

Next, in a switch transaction, the so-called loss leg of the futures straddle would be closed out through the purchase (or sale) of an identical offsetting position and replaced by a new position with a different delivery date. (Because an inverse relationship normally exists between the legs of a futures straddle, one

leg will have an unrealized loss while the other will have an unrealized gain.) The net loss on the closed leg of the futures straddle would be reported as a short-term capital loss in the first year of the transaction and would approximately equal the short-term capital gain incurred on closing out the purchased option position.

The final step of a typical option-straddle transaction occurred in the subsequent year, although not earlier than 6 months after the switch. Both legs of the futures straddle would be closed out by offsetting trades, resulting in a gain approximately equal to the loss incurred on the switch transaction in the previous year. The gain incurred would be reported as either a short-term or long-term capital gain in the second year of the transaction.

The second trading strategy employed by broker-dealers was the option-hedge transaction. In an option-hedge transaction, the sale of a call and/or put option was hedged by the purchase of a futures contract (to hedge the call) and/or the sale of a futures contract (to hedge the put). Shortly thereafter, the option positions would be closed out at a net loss through the purchase of an identical offsetting call and/or put option. Simultaneously with the purchase of the closing option positions, futures contracts would be executed to hedge the previously purchased and/or sold futures, thus forming one or more futures straddles. Finally, in the following year, the futures straddles would be closed out at a gain approximately equal in amount to the loss incurred on the sold options.

Because both the option-straddle transaction and the option-hedge transaction strategies resulted in a capital gain in the second year of the transaction, many petitioners attempted to defer the gain (and possibly convert it into long-term gain) to the subsequent

year by engaging in a rollover transaction. A rollover transaction simply entailed putting on another futures straddle in the second year of the transaction, subsequently closing out the loss leg in a switch, and then closing out the straddle at a gain in the following year.

Petitioners reported the following ordinary losses from their London options transactions, which respondent disallowed:

Petitioner	1975	1976	1977
Clark	($2,124,000)	$ 3,408,382)	-
Kazi	($ 518,000)	($ 971,754)	($ 202,320)
Fox	($ 263,913)	($ 606,564)	-
Horn	—	($ 140,975)	($ 155,118)
Massey	($ 608,000)	($ 970,195)	-
Fraites	($2,016,000)	($2,480,548)	-
Cademartori	($ 127,260)	($ 306,367)	($ 28,986)
Gutman	—	($ 140,172)	-
Gardner	($ 767,752)	($1,014,768)	($ 755,914)
Falk	($ 767,752)	($1,014,768)	($ 755,914)
Lerman	—	($ 195,168)	-
Sterling	($ 607,000)	($ 882,000)	-

DISCUSSION

Petitioners' motion for summary judgment is premised upon the fact that they were dealers in commodities within the meaning of section 108(b) at the time they executed their straddle transactions, a difference they believe critical in distinguishing their situation from that of the nondealers we addressed in Glass v. Commissioner, supra. Respondent, however, fails to concede that petitioners were dealers within the meaning of section 108(f) and Internal Revenue Code (I.R.C.) section 1402(i)(2)(B). We are unable to establish from the stipulated facts that petitioners were "person[s] who [were] actively engaged in trading [I.R.C.] 1256 contracts and [were] registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission" during the years at issue.

I.R.C. section 1402(i)(2)(B) and section 108(f). Therefore, petitioners' dealer status, a fact material to petitioners' position, remains in dispute. Because this Court may only grant summary judgment if "there is no genuine issue as to any material fact," we must, as petitioners concede on brief, deny petitioners' motion. Rule 121(b). See *Naftel v. Commissioner*, 85 T.C. 527, 529 (1985).

Respondent's cross-motion for summary judgment is based upon the legal theory that irrespective of whether petitioners are dealers or nondealers, the straddle transactions in question are shams devoid of economic substance. He asserts that since the purported transactions are shams in substance, the per se rule of section 108(b) does not apply to petitioners. Therefore, the ordinary losses generated by the straddle transactions should be disallowed for tax purposes as a matter of law. For purposes of evaluating the merit of the sham in substance theory, respondent concedes that petitioners were dealers within the meaning of section 108 and that the transactions factually occurred. Thus, there remains no genuine issue of material fact with respect to the issue of sham in substance. Respondent, however, continues to contest petitioners' dealer status and the factual occurrence of the straddle transactions in all contexts other than that of his legal theory. See *McLain v. Commissioner*, 67 T.C. 775, 778-779 (1977), and cases cited therein. Accordingly, the scope of our inquiry is limited to (1) whether petitioners' straddle transactions were shams in substance as a matter of law and if so, (2) assuming petitioners' dealer status, whether the per se presumption of section 108(b) will nonetheless act upon the putative losses arising from such transactions to characterize them as deductible "trade or business related."

In *Cook v. Commissioner*, 90 T.C. 975 (1988), this Court recently considered the impact of section 108(b) on commodities dealers who engage in straddle transactions which are devoid of economic substance. In our opinion, we specifically disallowed the deduction of putative losses incurred in the *Glass* straddle transactions by taxpayers who qualified as dealers within the meaning of section 108(f). 90 T.C. at 976-977. We believe that

BEST AVAILABLE COPY

the principles we establish in Cook require us to grant respondent's cross-motion for summary judgment.

We note at the outset that because the parties submitted their briefs prior to our entering the *Cook* decision, many of the assertions they now advance are identical to those previously evaluated and answered by the Court in Cook. Rather than repeat the detailed reasoning of *Cook* at this time, we feel it sufficient to limit our summary to those points petitioners reassert in opposition to the cross-motion presently before this Court.

We begin our analysis by considering whether the transactions in question are shams in substance. Unlike the taxpayers in *Cook*, who consistent with our holding in *Glass* stipulated that the straddle transaction at issue was a sham in substance (90 T.C. at 979-980), petitioners have not explicitly conceded this point. Therefore, we must examine the stipulated facts to determine the presence or absence of economic substance. Specifically, we must determine whether the transactions at issue in this case, which were stipulated to be of the same type as those described by the Court in *Glass*, are distinguishable from transactions we have previously found to lack economic substance.

As we stated in *Glass v. Commissioner*, 87 T.C. at 1174, the grand focus of our attention is the entire tax straddle scheme and not each separate straddle. See *Smith v. Commissioner*, 78 T.C. 350, 390-391 (1982). The stipulation submitted by the parties contains detailed information regarding the losses allegedly generated by closing out the "loss legs" of the various straddles. We are, however, somewhat troubled by the parties' failure to introduce into the stipulation specific information regarding the offsetting capital gain legs of the straddle transactions. Given the mandate that we view the factual materials presented and omitted and the inferences to be drawn from such materials and omissions in the light most favorable to the party opposing the motion in determining the absence of a material fact (*Jacklin v. Commissioner*, 79 T.C. 340, 344 (1982)), it might be argued

that the omission of capital gain information raises a material issue of fact that would prevent us from concluding as a matter of law that petitioners' transactions were shams in substance.

We do not, however, consider respondent's failure to produce a specific record of the offsetting straddle gains to be fatal. On the contrary, because petitioners stipulated that the capital gain incurred on closing out the second leg of the straddles was "approximately equal to the loss incurred * * * in the previous year," any inference we must make regarding the amount of petitioners' capital gains must be limited to an amount which would approximately offset the losses incurred on the prior straddle leg. We conclude, therefore, that whatever petitioners' actual gains were, they must by virtue of petitioners' stipulation necessarily fall within the parameters of the straddle transactions we found in *Glass* and *Cook* to be prearranged and shams in substance. The fact that the entire transaction produces a nominal net gain, an inference we draw in favor of petitioners, will not impute substance into an otherwise sham transaction. On the contrary, we specifically observed in *Glass* that a "very small" net economic gain might result from the closed straddle transaction (87 T.C. at 1157). However, after comparing the potential nominal economic gains with the prearranged and "very substantial" tax losses anticipated in the first year of the straddle, we concluded that the *Glass* transactions lacked economic substance. The parties have stipulated that petitioners' straddle transactions are similar to the generic transactions executed in *Glass*. We find no salient distinction in petitioners' transactions which would cause us to alter the characterization we affixed in Glass. Accordingly, we find as a matter of law that petitioners' transactions are devoid of economic substance.

Our inference that petitioners' closed-out straddle produced nominal if any economic gain is consistent with the conduct the parties demonstrated in motioning this Court for summary judgment. Petitioners' dockets were removed from the trial calendar based upon the representation that the remaining controversies at issue therein could be resolved by our determining the narrow legal issue of "whether the holding of *Glass* applied to

persons who were dealers under Section 108(b)." Because the parties stipulated that their transactions were similar to the generic *Glass* transactions, we believe they implicitly represented that their transactions, at best, produced only nominal gains. The extent to which the parties referred to *Glass* in their arguments persuades us that they thoroughly examined and understood the transactions involved therein. One would expect that if significant net economic gains — straddle gains minus straddle losses minus commissions — were generated by petitioners' transactions, petitioners' counsel would have brought this fact to our attention in the stipulation. No such distinguishing representation was made. We are therefore convinced that our inference regarding the extent of petitioners' economic gains comports with economic realities.

We next consider whether petitioners' assumed dealer status will trigger the application of section 108(b) to transmute putative losses into bona fide losses incurred in a trade or business. Like the taxpayers in Cook, petitioners place heavy emphasis upon our opinion in *King v. Commissioner*, 87 T.C. 1213 (1986) (Court reviewed), an opinion entered after *Glass* and prior to *Cook*. Marlowe King was a registered member of the Chicago Mercantile Exchange (CME), a domestic board of trade subject to regulation by the Commodities Futures Trading Corporation (CFTC). King was a commodities dealer within the meaning of I.R.C. section 1402(i)(2)(B) and section 108(f). King entered into various gold straddles during 1980 and 1981. King liquidated the loss legs of these straddles in 1980 and deducted a $1,452,900 short-term capital loss. The Commissioner disallowed the loss. He asserted in the statutory notice of deficiency that "The transactions at issue were either shams or devoid of the substance necessary for recognition for federal income tax purposes." 87 T.C. at 1216. King petitioned this Court for a summary judgment ruling that the claimed losses were deductible under section 108. King's affidavit in support of his motion detailed facts supporting the bona fide nature of his trading in gold contracts. 87 T.C. at 1217. The Commissioner opposed this motion on three grounds:

(1) Taxpayer failed to address the threshold issue of whether the transactions were shams;

(2) Taxpayer failed to show that he is entitled to the presumption under section 108(b) of the Tax Reform Act of 1984 and Temporary Regulation Section 1.165-13T; and

(3) Even if taxpayer were entitled to the presumption, a trial would nevertheless be required to resolve the "for profit" issue which is inherently factual. 87 T.C. at 1216.

The Commissioner, however, failed to allege or support any facts tending to demonstrate that King's trading transactions were shams in any sense. We held that "Under these circumstances, respondent has not shown that there is a genuine issue of sham for trial." 87 T.C. at 1217. We then granted King's motion for summary judgment based upon a finding that the specific gold straddles executed by King were not fictitious.

Petitioners assert that "The King analysis teaches that the 'economic sham' of *Glass* is inapplicable to taxpayers who qualify as dealers under Section 108." Petitioners misread our analysis. As we pointed out in *Cook* (90 T.C. at 982), we expressly refrained in King from drawing any conclusions as to what the result might be under other circumstances. In footnote 8, page 1219, of *King*, we said:

The per se rule of sec. 108(b) would not preclude us from finding for respondent in another case. The legislative history of the provision makes clear that it was not intended to apply "where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member." H. Rept. 99-426, at 911 (1985). [1986-3 C.B. (Vol. 2), at 911.] See also *DeMartino v. Commissioner*, T.C. Memo. 1986-263 [affd. F.2d (2d Cir., Nov. 23, 1988)].

In contrast with his unsupported allegation of sham in *King*, the Commissioner specifically alleged in *Cook* (90 T.C. at 980) that the prearranged and fictitious nature of the *Glass* straddles

caused the transactions to be shams in substance. After assuming the *Glass* transactions were not fictitious, we concluded that they were nonetheless prearranged. We then concluded that Congress never intended section 108(b) to automatically characterize all dealer derived straddle losses as losses incurred in a trade or business. Rather, we determined that Congress contemplated that "the presumption [that a straddle loss was incurred in a trade or business] would not be available in any cases were the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member." 90 T.C. at 984 citing H. Rept. 99-426, 1986-3 C.B. (Vol. 2) 911. Consistent with this Congressional intent, we held that:

> it is appropriate before applying the per se rule of section 108(b) to enquire whether straddle transactions were fictitious, prearranged, or otherwise in violation of the rules of the exchange, and if so, whether there were losses actually incurred. [Footnote ref. omitted.] Since the straddle transactions in Glass were prearranged, causing the transactions to lack economic substance, petitioner incurred no losses to which the per se rule can be applied. * * * [90 T.C. at 986.]

As discussed above, petitioners stipulated that their straddle transactions were similar to the generic *Glass* schemes we found to be prearranged and shams in substance. See *Cook v. Commissioner*, 90 T.C. at 985-986. Accordingly, we find as a matter of law that petitioners' straddle transactions produced no losses to which the per se rule of section 108(b) can be applied. See *DeMartino v. Commissioner*, F.2d (2d Cir., Nov. 23, 1988), affg. T.C. Memo. 1986-263 (holding that the Court may inquire into the economic substance of a dealer's commodity trading in determining whether section 108(b) is applicable). Likewise, since the straddle transactions were shams, gains reported by petitioners in the latter years do not constitute taxable income to them.

To reflect the foregoing,

Appropriate orders will be issued and decisions will be entered under Rule 155 in docket Nos. 3453-79, 10069-79, 10233-79, 10234-79, 10236-79, 10237-79, 10238-79, 10239-79, 10240-79, 10241-79, 10242-79, 10243-79, 10244-79, 13246-80, 13247-80, 13248-80, 21879-80, 22240-80, 22291-80, 22292-80, 22293-80, 22294-80, 22295-80, 22296-80, 22297-80, 23476-81, 23477-81, 23479-81, 23614-81, 31359-81, 974-82, 13919-82, 13920-82, 16675-83.

APPENDIX A

Section 108 of Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630, as amended by section 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2817.

SEC. 108. TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.

(a) GENERAL RULE. — For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions -

(1) which are entered into before 1982 and form part of a straddle, and

(2) to which the amendments made by title V of such Act [Economic Recovery Tax Act of 1981] do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business.

(b) LOSS INCURRED IN A TRADE OR BUSINESS. — For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.

(c) NET LOSS ALLOWED. – If any loss with respect to a position described in paragraphs (1) and (2) of subsection (a) is not allowable as a deduction (after applying subsections (a) and (b)), such loss shall be allowed in determining the gain or loss from dispositions of other positions in the straddle to the extent required to accurately reflect the taxpayer's net gain or loss from all positions in such straddle.

(d) OTHER RULES. – Except as otherwise provided in subsections (a) and (c) and in sections 1233 and 1234 of such Code, the determination of whether there is recognized gain or loss with respect to a position, and the amount and timing of such gain or loss, and the treatment of such gain or loss as long-term or short-term shall be made without regard to whether such position constitutes part of a straddle.

(e) STRADDLE. – For purposes of this section, the term "straddle" has the meaning given to such term by section 1092(c) of the Internal Revenue Code of 1954 as in effect on the day after the date of the enactment of the Economic Recovery Tax Act of 1981, and shall include a straddle all the positions of which are regulated futures contracts.

(f) COMMODITIES DEALERS. – For purposes of this section, the term "commodities dealer" means any taxpayer who -

(1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle), or

(2) was a member of the family (within the meaning of section 704(e)(3) of such Code) of an individual described in paragraph (1) to the extent such member engaged in commodities trading through an organization the members of which consisted solely of -

(A) 1 or more individuals described in paragraph (1), and

(B) 1 or more members of the families (as so defined) of such individuals.

(g) REGULATED FUTURES CONTRACTS. — For purposes of this section, the term "regulated futures contracts" has the meaning given to such term by section 1256(b) of the Internal Revenue Code of 1954 (as in effect before the date of enactment of this Act).

(h) SYNDICATES. — For purposes of this section, any loss incurred by a person (other than a commodities dealer) with respect to an interest in a syndicate (within the meaning of section 1256(e)(3)(B) of the Internal Revenue Code of 1954) shall not be considered to be a loss incurred in a trade or business.

UNITED STATES TAX COURT

CHARLES H. FALK and JOAN A. FALK,	)	
Petitioners,	)	
v.	)	Docket No. 10242-79
COMMISSIONER OF INTERNAL REVENUE	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed December 15, 1988, and the Stipulation previously filed with the Court, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year 1975 in the amount of $605,996.00.

(Signed) ARTHUR L. NIMS, III

Judge

Entered: January 30, 1991

UNITED STATES TAX COURT

HILARY P. GARDNER and JUDITH GARDNER,	)	
Petitioners,	)	
v.	)	Docket No. 10238-79
COMMISSIONER OF INTERNAL REVENUE	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed December 15, 1988, and the Stipulation previously filed with the Court, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That the following statement shows the petitioners' income tax liability for the taxable year 1975:

	1975
Tax liability	$689,030.00
Tax assessed and paid April 15, 1976	186,296.00
Deficiency to be assessed	$502,734.00

Tax paid after mailing of notice of deficiency, but not assessed, 12/31/82	$230,595.00
Unpaid deficiency	$272,139.00

(Signed) ARTHUR L. NIMS, III
Judge

Entered: January 30, 1991

UNITED STATES TAX COURT

JACK M. FOX and MARLISS S. FOX, et al.,	)	Docket Nos. 3453-79, 13246-80, 23476-81, 10069-79, 13247-80,
Petitioners,	)	23477-81, 10233-79, 13248-80, 23478-81,
v.	)	10234-79, 21879-80, 23479-81, 10236-79,
COMMISSIONER OF INTERNAL REVENUE,	)	22240-80, 23480-81, 10237-79, 22291-80, 23614-81, 10238-79,
Respondent.	)	22292-80, 31359-81, 10239-79, 22293-80, 974-82, 10240-79, 22294-80, 13919-82, 10241-79, 22295-80, 13920-82, 10242-79, 22296-80, 16675-83, 10243-79, 22297-80, 21394-83, 10244-79,

STIPULATION OF FACTS

PREAMBLE

The below-signed parties agree to this First Stipulation of Facts for Motion for Summary Judgment pursuant to the terms of the preamble, unless specifically expressed otherwise herein. For the purpose of the Motion for Summary Judgment only, all stipulated facts shall be conclusive, all stipulated exhibits shall be considered authentic, all copies shall be considered electronic reproductions of the originals and shall be treated as if originals. Neither party shall be bound by any item stipulated to as a fact except for purposes of this summary judgment motion.

This stipulation is not to be construed as a concession by the respondent that the transactions at issue actually occurred.

1. At the time of the filing of the petition, the petitioners' addresses were as follows:

(a) Clark, Reed & Audrey I.
Valentine's Lane
Old Brookville, New York

(b) Kazi, Ralph & Jean
99 Mamaroneck Road
Scarsdale, New York

(c) Fox, Jack M. & Marliss S.
P. O. Box 4304,
Kawaihae, Hawaii 96743

(d) Horn, Terence J & Jean
Taylor Road
Mount Kisco, New York 10549

(e) Massey, Dwight & Joann V.
154 Beechwood Road
Ridgewood, New Jersey 07450

(f) Fraites, Joseph L. & Evelyn
747 Johnston Drive
Watchnung, New Jersey 07060

(g) Cademartori, Dominick & Jean
30 Renfrew Road
Spring Valley, New York 10977

(h) Gutman, Daniel & Judith
6 C Blue Sea Lane
Kings Point, New York 11024

(i) Gardner, Hilary & Judith
283 Wheatley Road
Old Westbury, New York 11568

(j) Falk, Charles & Joan
19 Pound Hollow Road
Glen Head, New York 11545

(k) Lerman, Charles & Barbara
30 Galloping Hill Circle
Holmdel, New Jersey 07733

(l) Sterling, Arturo & Lydia
c/o Czarnikow-Rionda, Co., Inc.
120 Wall Street
New York, New York 10005

2. Attached as the following Joint Exhibits are copies of the petitioners' federal income tax returns for the years at issue in these cases:

Exhibit No.	*Petitioners*	*Docket Nos.*	*Tax Years*
1-A	Reed & Audrey I. Clark	10240-79	1975
2-B	Reed & Audrey I. Clark	22291-80	1976
3-C	Reed & Audrey I. Clark	23479-81	1977
4-D	Ralph and Jean Kazi	10233-79	1975
5-E	Ralph and Jean Kazi	22296-80	1976
6-F	Ralph and Jean Kazi	23478-81	1977
7-G	Jack M. & Marliss S. Fox	10069-79	1975
8-H	Jack M. & Marliss S. Fox	21879-80	1976
9-I	Terence J. & Jean Horn	10236-79	1975
10-J	Terence J. & Jean Horn	13248-80	1976
11-K	Terence J. & Jean Horn	16675-83	1977
12-L	Terence J. & Jean Horn	16675-83	1978
13-M	Terence J. & Jean Horn	16675-83	1979
14-N	Dwight B. & Joann V. Massey	10241-79	1975
15-O	Dwight B. & Joann V. Massey	22297-80	1976
16-P	Dwight B. & Joann V. Massey	23614-81	1977
17-Q	Joseph L. & Evelyn Fraites	10243-79	1975
18-R	Joseph L. & Evelyn Fraites	22295-80	1976
19-S	Joseph L. & Evelyn Fraites	23476-81	1977
20-T	Dominick & Jean Cademartori	10244-79	1975

21-U	Dominick & Jean Cademartori	22293-80	1976
22-V	Dominick & Jean Cademartori	23480-81	1977
23-W	Dominick & Jean Cademartori	21394-83	1978
24-X	Dominick & Jean Cademartori	21394-83	1979
25-Y	Dominick & Jean Cademartori	21394-83	1980
26-Z	Daniel and Judith Gutman	10234-79	1975
27-AA	Daniel and Judith Gutman	13247-80	1976
28-AB	Hilary & Judith Gardner	10238-79	1975
29-AC	Hilary & Judith Gardner	22240-80	1976
30-AD	Hilary & Judith Gardner	31359-81	1977
31-AE	Charles & Joan Falk	10242-79	1975
32-AP	Charles & Joan Falk	22292-80	1976
33-AG	Charles & Joan Falk	974-82	1977
34-AH	Charles & Joan Falk	13920-82	1978
35-AI	Charles & Barbara Lerman	10239-79	1975
36-AJ	Charles & Barbara Lerman	13246-80	1976
37-AK	Arturo & Lydia Sterling	10237-79	1975
38-AL	Arturo & Lydia Sterling	22294-80	1976
39-AM	Arturo & Lydia Sterling	23477-81	1977
40-AN	Arturo & Lydia Sterling	13919-82	1978

3. Attached as the following Exhibits are copies of the notices of deficiency for the years at issue in these cases:

Exhibit No.	*Petitioners*	*Docket Nos.*	*Tax Years*
41-AO	Reed & Audrey I. Clark	10240-79	1975
42-AP	Reed & Audrey I. Clark	22291-80	1976
43-AQ	Reed & Audrey I. Clark	23479-81	1977
44-AR	Ralph and Jean Kazi	10233-79	1975
45-AS	Ralph and Jean Kazi	22296-80	1976
46-AT	Ralph and Jean Kazi	23478-81	1977
47-AU	Jack M. & Marliss S. Fox	10069-79	1975
48-AV	Jack M. & Marliss S. Fox	21879-80	1976
49-AW	Terence J. & Jean Horn	10236-79	1975
50-AX	Terence J. & Jean Horn	13248-80	1976
51-AY	Terence J. & Jean Horn	16675-83	1977-1979
52-AZ	Dwight B. & Joann V. Massey	10241-79	1975

53-BA	Dwight B. & Joann V. Massey	22297-80	1976
54-BB	Dwight B. & Joann V. Massey	23614-81	1977
55-BC	Joseph L. & Evelyn Fraites	10243-79	1975
56-BD	Joseph L. & Evelyn Fraites	22295-80	1976
57-BE	Joseph L. & Evelyn Fraites	23476-81	1977
58-BF	Dominick & Jean Cademartori	10244-79	1975
59-BG	Dominick & Jean Cademartori	22293-80	1976
60-BH	Dominick & Jean Cademartori	23480-81	1977
61-BI	Dominick & Jean Cademartori	21394-83	1978-1980
62-BJ	Daniel and Judith Gutman	10234-79	1975
63-BK	Daniel and Judith Gutman	13247-80	1976
64-BL	Hilary & Judith Gardner	10238-79	1975
65-BM	Hilary & Judith Gardner	22240-80	1976
66-BN	Hilary & Judith Gardner	31359-81	1977
67-BO	Charles & Joan Falk	10242-79	1975
68-BP	Charles & Joan Falk	22292-80	1976
69-BQ	Charles & Joan Falk	974-82	1977
70-BR	Charles & Joan Falk	13920-82	1978
71-BS	Charles & Barbara Lerman	10239-79	1975
72-BT	Charles & Barbara Lerman	13246-80	1976
73-BU	Arturo & Lydia Sterling	10237-79	1975
74-BV	Arturo & Lydia Sterling	22294-80	1976
75-BW	Arturo & Lydia Sterling	23477-81	1977
76-BX	Arturo & Lydia Sterling	13919-82	1978

4. Respondent's statutory notices issued in these cases disallowed tin and silver options ordinary losses claimed by the petitioners from transactions which they engaged in on the London Metal Exchange (hereinafter "LME").

5. The silver options and futures were traded through Lonconex on the LME.

6. The tin options and futures were transacted on the LME through Bear Stearns.

7. London options transactions at issue in this case are of the same type as those described by the Court in *Glass et al. v. Commissioner*, 87 T.C. No. 68 (Nov. 17, 1986) in the Court's findings

of Fact, Section III A. Through the use of such transactions, ordinary losses were incurred in the initial years and capital gains were realized in the subsequent years.

Short term capital gains which were generated by the transactions were subsequently converted into long term capital gains through new futures straddles in silver, copper and other commodities initiated on U. S. exchanges, such as the Commodities Exchange Inc. ("Comex") and foreign exchanges. Some of these futures straddles were closed by petitioners Massey, Fraites, Sterling, Clark, Cademartori and Kazi either by taking delivery of physical commodities in settlement of long future positions and delivering them against the short futures position, or by taking delivery and selling the physical commodity, realizing long term capital gains.

The following is a schedule of ordinary losses incurred with regard to the transactions at issue and disallowed by the respondent:

SCHEDULE OF DISALLOWED LOSSES WITH RESPECT TO THE TRANSACTIONS AT ISSUE

Petitioners	*1975*	*1976*	*1977*
Clark (Losses)	($ 2,124,000)	($ 3,408,382)	
Kazi (Losses)	($ 518,000)	($ 971,754)	($202,320)
Fox (Losses)	($ 263.913)	($ 606,564)	
Horn (Losses)		($ 140,975)	($155,118)
Massey (Losses)	($ 608.000)	($ 970,195)	
Fraites (Losses)	($ 2,016,000)	($ 2,480,548)	
Cademartori (Losses)	($ 127,260)	($ 306,367)	($ 28,986)
Gutman (Losses)		($ 140,172)	
Gardner (Losses)	($ 767.752)	($ 1,014,768)	($755.914)
Falk (Losses)	($ 767,752)	($ 1,014,768)	($755,914)
Lerman (Losses)		($ 195.168)	
Sterling (Losses)	($ 607,000)	($ 882.000)	

9. All of the petitioner-wives are parties to these proceedings only by virtue of their filing joint returns with petitioner-husbands.

10. All of the petitioner-husbands (hereinafter petitioners) in these cases were during the years at issue either employee/officers or shareholders, or both. of Czarnikow-Rionda Company. Inc., a subchapter 5 corporation, and/or, after September, 1980. of Czarnikov Rionda Trading Co., Inc., and/or of Rionda de Pass Ltd. (collectively "Rionda").

11. During the years at issue, Rionda regularly traded in physical sugar, and sugar futures and options on sugar futures for its own account. It also acted as a broker for its customers in the purchase and sale of sugar futures and options on sugar futures.

12. Rionda, during the years at issue, was a member of the Nev York Coffee and Sugar Exchange (hereinafter "the Exchange"). The Exchange is now known as the New York Coffee, Sugar and Cocoa Exchange. Attached as Exhibits 77-BY, 7B-BZ and 79-CA are copies of relevant rules of the Exchange.

13. Under the Rules of the Exchange, a corporation cannot obtain membership in its own right, but must have membership privileges conferred upon it by an individual member of the Exchange.

14. Corporation privileges were conferred upon Rionda on the Exchange based upon the membershp privileges of Falk and Massey during the years at issue. Based upon Clark's membership, corporation privileges were conferred upon Sugar Cane Growers, a customer of Rionda, during the years at issue. Based upon Fraites' membership, corporation privileges were conferred upon Rionda de Pass Ltd., during the years at issue.

15. The Exchange has been designated as a contract market by the Commodity Futures Trading Commission (hereinafter "CFTC") since July 18, 1975. Attached as Exhibit 80-CB is a

copy of the Commodity Exchange Act, the Commodity Futures Trading Commission Act of 1974, the Futures Trading Act of 1978, the Futures Trading Act of 1982, and the Futures Trading Act of 1986.

16. During the years at issue Rionda was registered as a Futures Commission Merchant with the C.F.T.C.

17. The following petitioners were all of the shareholders of Rionda from 1975 - 1976: Clark, Massey, Gardner, Sterling, Fraites, Falk, Fox, Cademartori, and Kazi.

18. In 1977, the shareholders of Rionda were Clark, Massey, Gardner, Sterling, Fraites, Falk, Cademartori and Kazi.

19. From 1975 - 1977, the following petitioners were officers of Rionda:

President/Chairman of the Board	Reed Clark
Executive Vice President/President	Joseph L. Fraites
Vice President/Executive Vice President	Charles H. Falk
Vice President	Dwight B. Massey
Vice President	Hilary P. Gardner
Vice President	Arturo Sterling
Vice President	Ralph B. Kazi
Vice President	Dominick Cademartori
Assistant Vice President	Daniel Gutman

20. Petitioners Horn and Lerman were assistant vice presidents in 1977.

21. Petitioner Fox was a Vice President of Rionda through 1976 and Managing Director/Chairman of the Board of Rionda de Pass, Ltd., a British subsidiary of Rionda.

22. The following petitioners were individual members of the Exchange during the years at issue:

Petitioner	*Membership Period*	*Membership No.*
Clark	1/1/74 to 12/31/80	091
Falk	1/1/74 to 12/31/80	251
Fox	2/8/62 to 9/26/76	120
Fraites	1/1/74 to 12/31/80	256
Massey	1/1/74 to 12/31/80	031
Gardner	4/14/76 to 5/30/83	055

23. None of the remaining petitioners was a member of any Exchange during the years at issue.

24. Prior to January 1975, membership status with the Exchange automatically included floor trading rights if the member met the financial requirements of a floor trader. Effective January 1975, the Exchange required separate applications for membership and floor trading privileges, however, existing members as of January 1975 were entitled to retain their floor trading privileges, subject to the financial requirements of floor traders. See Exhibit 81-CC, letter from the Exchange to Samuel Brodsky. dated January 30, 1987.

25. None of the petitioners has been registered with the CFTC as a floor broker.

26. A floor broker is one who effects transactions on the floor of the Exchange for other parties. Registration of floor brokers was required under the Commodities Exchange Act, at least as early as 1970.

27. Floor traders, on the other hand, are members who generally trade for their own account. Before the CFTC entered the scene in mid-1975, the operation of the Exchange was less structured than it became after the advent of the CFTC, and a member, acting as a floor trader, was permitted access to the floor to effect transactions for himself or his own company and could do so upon signing the register. Petitioners have no copies of applications for floor trading privilege numbers (i.e., badges), and none were required before mid-1975. Even today, a member

may have access to the floor upon written request to effect a trade. Each of the petitioners who was an Exchange member from time to time prior to mid-1975 (and possibly on one or more occasions thereafter) traded on the floor for Rionda.

28. Reed Clark was the President of Rionda until 1976 and thereafter Chairman. He was the Chief Executive Officer of Czarnikow-Rionda Company, Inc., and/or Czarnikow-Rionda Trading Company, Inc., (collectively, "Rionda") throughout the period 1974 to 1980. He exercised all the functions of such office. He was a member of the Exchange from 1955 and through 1980. He frequently served as a member of one or more committees of the Exchange.

29. Joseph L. Fraites was Executive Vice President of Rionda commencing in 1969 until 1976, and thereafter President. He was the Chief Operating Officer of Rionda and, as such, exercised ultimate immediate authority with respect to Rionda's affairs. Mr. Fraites became a member of the Exchange in 1955 and continues as a member to date. He has served in numerous capacities at the Exchange and acted as Chairman of the Board of the Exchange for many years.

30. Arturo Sterling was a Vice President of Rionda from 1974 through 1980 and was responsible for trade in raw and refined sugar with Latin American countries and the Republic of the Philippines. Mr. Sterling was not a member of the Exchange or any other exchange during the period in questions.

31. Charles H. Falk was Executive Vice President of Rionda and was Rionda's chief trader. Mr. Falk became a member of the Exchange in 1970 and continues as such to date. He has held positions on many committees of the Exchange, including Membership, Arbitration, Control, Margin, Option and Adjudication. He has been a director of the Clearing House since 1971 and has been Chairman of the Board of the Exchange at various times.

32. H. Paul Gardner was a Vice President of Rionda and a senior trader with particular responsibilities for trade with the Far East. In 1975, Mr. Gardner's responsibilities were expanded to include European trading and, in August 1978, he moved to London where he became the director in charge of trading for Rionda's London subsidiary, Rionda de Pass Ltd. Mr. Gardner served in London in that capacity until May of 1983. He has been a member of the Exchange since April 1976 and has served on its Business Conduct Committee, Membership Committee, Control Committee, Sugar Committee, Nominating Committee, World Spot Price Roster, Special Working Group to Study Options, and has represented the Exchange at United Nations sponsored International Sugar Agreement meetings. Mr. Gardner's initial transactions and losses arose in 1975 when he was not a member of the Exchange, or any other exchange.

33. Dwight B. Massey was a Vice President of Rionda throughout the 1974-1980 period and his principal duties consisted of marketing raw sugar to U.S. refineries and industrial users; and planning and aiding in the purchase of sugar for U.S. destinations. Mr. Massey became a member of the Exchange on January 9, 1970 and continued as such through 1980 and thereafter. He has served on many committees of the Exchange.

34. Dominick A. Cademartori was a Vice President of Rionda and in charge of its Shipping/Invoice Department. As such, he supervised the activities of the department which conducted the physical movements of sugar, chartering of vessels, establishing letters of credit, procuring insurance, negotiating shipping documents, invoicing. and the like. Mr. Cademartori was not a member of the Exchange or any other Exchange during the periods at issue.

35. Jack M. Fox was a Vice President and one of the senior traders for Rionda. For some time prior to January 1, 1974 and thereafter through December 31, 1976, Mr. Fox served as Managing Director of Rionda de Pass Ltd., a wholly-owned subsidiary of Rionda, and thereafter, from January 1, 1977 through November 20, 1978, as Chairman of its Board. His duties

included the management, direction, trading and overall strategy of Rionda de Pass Ltd. Mr. Fox was a member of the Exchange until August 26, 1976.

36. Ralph A. Kazi was a Vice President of Rionda and its sugar analyst. His principal duties consisted of the collection and evaluation of data (as, for example, acreages planted for sugarcane and beets, yields, extraction rates), consumption, exports, imports, inventories, legislation and government regulations — domestic and foreign — which would affect the price of sugar, forecasting trends in production and consumption and balances between the two, providing information to customers of Rionda, and development of customer relations. Mr. Kazi was not a member of the Exchange or any other Exchange during the period at issue.

37. Daniel Gutman was initially Assistant Vice President and later a Vice President of Rionda. His principal responsibility consisted of trade in sugar with producers in Argentina, Colombia, El Salvador, Guatemala and Honduras. Mr. Gutman was not a member of the Exchange or any other Exchange during the periods at issue.

38. Charles Lerman was a Vice President of Rionda. He was responsible for execution of Rionda's trading decisions and for the execution of the futures business of Rionda's customers. Mr. Lerman was not a member of the Exchange or any other Exchange during the periods at issue.

39. Terence J. Horn was an Assistant Vice President of Rionda and was one of its senior futures traders. Subsequent to 1977 he also engaged in trading of physical sugar on behalf of Rionda. Mr. Horn was not a member of the Exchange, or any other exchange during the periods at issue.

40. Rionda employed one or two floor brokers, none of whom is a petitioner in these cases, to execute trades on behalf of Rionda on the Exchange during the periods at issue in these cases. Theodore G. Jackson was one of the floor brokers employed by

Rionda since December 17, 1973, when he acquired a membership on the Exchange. Clifford S. Evans was the other floor broker employed by Rionda for the years in issue, acquiring his membership on August 26, 1976.

41. During the period July 8, 1975 through November 19, 1980, the following petitioners were registered with the CFTC as "associated persons," in the employ of Rionda:

(a) Reed Clark;
(b) Ralph Kazi;
(c) Joseph Fraites;
(d) Arturo Sterling;
(e) Charles Falk;
(f) Dwight B. Massey;
(g) Dominick Cademartori;
(h) Daniel Gutman;
(i) Charles Lerman; and,
(j) Terence Horn

42. During the period July 8, 1975 through March 13, 1980, petitioner Hilary Gardner was registered with the CFTC as an "associated person," in the employ of Rionda.

43. Petitioner Jack M. Fox was registered with the Commodity Futures Trading Commission as a "foreign associated person," in the employ of Rionda as of January 6, 1976.

44. During the period in issue, none of the petitioners, other than as a shareholder/officer/employee of Rionda, traded for the account of any person or entity other than of customers of Rionda and Rionda itself.

45. At all times during the years 1975 through 1981, Rionda maintained substantial positions in physical sugar and in sugar futures contracts on the Exchange.

46. During such period, Rionda, on a daily basis, purchased and sold sugar future contracts on the Exchange as hedges

against contracts for the purchase or sale of physical sugar, for speculation purposes, as arbitrage positions against future positions which it held on other sugar exchanges such as Paris or London, and/or straddles.

47. Petitioners Clark, Fraites, Massey, Falk, Gardner, Sterling, Fox, Gutman, Horn, Lerman and Kazi participated in the following activities on behalf of Rionda:

(A). The decision making process by which Rionda's long and short term physical and futures positions were determined;

(B). Within the position parameters determined as set forth in (A), exercised discretion in purchasing and selling physical sugar and sugar futures on the Exchange and on other exchanges such as Paris and London; and,

(C). Exercised discretion in purchasing and selling physical sugar and sugar futures on the Exchange and other exchanges for the purposes of conducting Rionda's business as set forth in paragraph 46 of this Stipulation.

(D). Executed futures trades on a directed or discretionary basis on the Exchange for customers of Rionda.

With the exception of Gutman, the non-shareholder-petitioners had more limited authority than the shareholder-petitioners in the above-described decision making process.

48. Petitioner Dominick A. Cademartori advised the petitioners specified in paragraph 47 of the shipping and other costs affecting their purchase and sales decisions.

49. Attached as Exhibit 82-CD is a copy of a letter dated February 2, 1977 from the C.F.T.C. and a letter dated February 10, 1977 from Rionda.

50. If respondent's motion for summary judgment is granted, the determination of the deficiency owed by a petitioner should take into account the following:

(a) Where the statutory notice specifies "increase in capital gains due to commodity transactions" or words having a similar effect, and such gains relate to the commodities transactions at issue, such increases should be eliminated.

(b) Net capital gains and/or losses which are related to commodity straddle transactions and are involved in years for which petitions have been filed should be eliminated.

(c) Such other adjustments should be made as may be necessary to give effect in these cases to the decision of the Court in the *Glass* case that capital gains in year two and thereafter reported by a petitioner arising from the commodity transactions at issue do not constitute taxable income to him.

WILLIAM F. NELSON
Chief Counsel
Internal Revenue Service

By: /s/Victoria Wilson Fernandez
VICTORIA WILSON FERNANDEZ
Special Trial Attorney
District Counsel, Brooklyn
Uniondale Avenue at
Hempstead Turnpike
Uniondale, New York 11553
Tel. No. (516) 560-8480

/s/Elias Rosenzweig
ELIAS ROSENZWEIG
Attorney for Petitioners
61 Broadway
New York, New York 10006

/s/Samuel Brodsky
SAMUEL BRODSKY
Attorney for Petitioners
200 Park Avenue
New York, New York 10166

/s/Benjamin J. Golub
BENJAMIN J. GOLUB
Attorney for Petitioners
10 East 40th Street
New York, New York 10016

SECTION 108

Section 108 of Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630, as amended by section 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2817.

SEC. 108. TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.

(a) GENERAL RULE. – For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions –

(1) which are entered into before 1982 and form part of a straddle, and

(2) to which the amendments made by title V of such Act [Economic Recovery Tax Act of 1981] do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business.

(b) LOSS INCURRED IN A TRADE OR BUSINESS. – For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.

(c) NET LOSS ALLOWED. – If any loss with respect to a position described in paragraphs (1) and (2) of subsection (a) is not allowable as a deduction (after applying subsections (a) and (b)), such loss shall be allowed in determining the gain or loss from dispositions of other positions in the straddle to the extent required to accurately reflect the taxpayer's net gain or loss from all positions in such straddle.

(d) OTHER RULES. – Except as otherwise provided in subsections (a) and (c) and in sections 1233 and 1234 of such Code, the determination of whether there is recognized gain or loss with respect to a position, and the amount and timing of such gain or loss, and the treatment of such gain or loss as long-term or short-term shall be made without regard to whether such position constitutes part of a straddle.

(e) STRADDLE. – For purposes of this section, the term "straddle" has the meaning given to such term by section 1092(c) of the Internal Revenue Code of 1954 as in effect on the day after the date of the enactment of the Economic Recovery Tax Act of 1981, and shall include a straddle all the positions of which are regulated futures contracts.

(f) COMMODITIES DEALERS. – For purposes of this section, the term "commodities dealer" means any taxpayer who –

(1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle), or

(2) was a member of the family (within the meaning of section 704(e)(3) of such Code) of an individual described in paragraph (1) to the extent such member engaged in commodities trading through an organization the members of which consisted solely of –

(A) 1 or more individuals described in paragraph (1), and

(B) 1 or more members of the families (as so defined) of such individuals.

(g) REGULATED FUTURES CONTRACTS. – For purposes of this section, the term "regulated futures contracts" has the meaning given to such term by section 1256(b) of the Internal Revenue Code of 1954 (as in effect before the date of enactment of this Act).

(h) SYNDICATES. — For purposes of this section, any loss incurred by a person (other than a commodities dealer) with respect to an interest in a syndicate (within the meaning of section 1256(e)(3)(B) of the Internal Revenue Code of 1954) shall not be considered to be a loss incurred in a trade or business.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 91-1360, 91-1361, 91-1364, 91-1365
91-1366, 91-1369, 91-1370, 91-1371,
91-1372, and 91-1373

DWIGHT B. & JOANN V. MASSEY,

v.

COMMISSIONER OF INTERNAL REVENUE.

Appellant in No. 91-1360 and 91-1361

JOSEPH L. & EVELYN FRAITES

v.

COMMISSIONER OF INTERNAL REVENUE.

Appellant in Nos. 91-1364 and 91-1365

CHARLES S. & BARBARA LERMAN,

v.

COMMISSIONER OF INTERNAL REVENUE.

Appellant in No. 91-1366

DWIGHT B. and JOANN V. MASSEY,

Appellants in Nos. 91-1369 and 91-1370

v.

COMMISSIONER OF INTERNAL REVENUE.

JOSEPH L. & EVELYN FRAITES,

Appellants in No. 91-1371

v.

COMMISSIONER OF INTERNAL REVENUE.

JOSEPH L. & EVELYN S. FRAITES,

v.

COMMISSIONER OF INTERNAL REVENUE

Joseph L. and Evelyn Fraites

Appellants in No. 91-1372

CHARLES S. & BARBARA LERMAN,

Appellants in No. 91-1373

v.

COMMISSIONER OF INTERNAL REVENUE.

On Appeal from United States Tax Court
Docket Nos. 79-10241, 80-22297, 79-10243, 81-23476, and 80-13246
(Tax Court Judge:
Honorable Arthur L. Nims, III)

Submitted Under Third Circuit Rule 12(6)
November 19, 1991

Before: MANSMANN, COWEN and ROTH,
Circuit Judges

JUDGMENT ORDER

After consideration of all contentions raised by appellants,

IT IS ADJUDGED AND ORDERED that the decisions of the United States Tax Court be and are hereby affirmed.

Costs to be taxed against appellants in Massey, Nos. 91-1369 and 91-1370, Fraites, Nos. 91-1371 and 91-1372, and Lerman, No. 91-1373.

BY THE COURT.

(Signed) JANE R. ROTH

Circuit Judge

Attest:

(Signed) SALLY MRVOS

Sally Mrvos, Clerk

DATED; November 22, 1991

Filed July 17, 1991

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 90-1813, 90-1814, 90-1815,
90-1835, 90-1836, 90-1837

CHARLES S. LERMAN and BARBARA LERMAN,

Cross-Appellants at No. 90-1835
Appellees at No. 90-1813

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant at No. 90-1813
Cross-Appellee at No. 90-1835

JOSEPH L. FRAITES and EVELYN FRAITES,

Cross-Appellants at No. 90-1836
Appellees at No. 90-1814

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant at No. 90-1814
Cross-Appellee at No. 90-1836

DWIGHT B. MASSEY and JOANN V. MASSEY,
Cross-Appellants at No. 90-1837
Appellees at No. 90-1815

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellant at No. 90-1815
Cross-Appellee at No. 90-1837

On Appeal from the United States Tax Court
T.C. Nos. 79-10239, 80-22295, 81-23614

Argued June 6, 1991

BEFORE: SLOVITER, *Chief Judge*, and
GREENBERG and HIGGINBOTHAM,
Circuit Judges

(Filed: July 17, 1991)

Elias Rosenzweig (Argued)
Stanley Klein
Michael Weitzner
Brauner, Baron, Rosenzweig,
Kligler, Sparber, Bauman
& Klein
61 Broadway, 18th Floor
New York, New York 10006
Attorneys for Appellants-
Cross-Appellees

Shirley D. Peterson, Assistant
Attorney General
Kenneth L. Greene (Argued)
Gary R. Allen
Kimberly S. Stanley
United States Department
of Justice
Tax Division
Post Office Box 502
Washington, D.C. 20044
Attorneys for Appellees-
Cross-Appellants

OPINION OF THE COURT

GREENBERG, *Circuit Judge.*

Introduction

This case involves the continuing saga of a crackdown by the Commissioner of Internal Revenue on a tax shelter device we will call the "option-straddle transaction" and the divers attempts of various taxpayers to avoid the consequences of this crackdown.

The particular straddle transactions involved silver options on the London Metals Exchange. Appellant-taxpayers, Charles S. Lerman, Joseph L. Faites, and Dwight B. Massey, who on this appeal are assumed to be commodities dealers, engaged in the transactions on the Exchange, and deducted losses, for 1975, 1976, and 1977 purportedly incurred in those transactions. The Commissioner disallowed the deductions and assessed deficiencies against them. The appellants sought a redetermination of the deficiencies in the Tax Court, and both sides moved for summary judgment.

The Tax Court granted the Commissioner's motion, holding that the transactions were devoid of economic substance and therefore created no "loss" for which a deduction could be based. *Fox v. Comm'r*, 56 T.C.M. (CCH) 863 (1988). The Tax Court rejected the appellants' argument that, because they were commodities dealers, section 108(b) of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 108(b), 98 Stat. 494, 630, *as amended by* the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(d)(2), (4), 100 Stat. 2085, 2817-18, *reprinted at* I.R.C. (26 U.S.C.) § 1092 note (1988) (hereinafter "section 108(b)"), countenanced the deductions. Section 108*(a)* provides that "any loss" "form[ing] part of a [pre-1982] straddle" "shall be allowed" "if such loss is incurred in a trade or business" *or* "if such loss is incurred in a transaction entered into for profit though not connected with a trade or business." I.R.C. § 1092 note (section 108(a)). Section 108*(b)* provides an irrebuttable presumption that any straddle-related "*loss* incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business." *Id.* (section 108(b)) (emphasis added). The Tax Court held that the irrebuttable trade-or-business-loss presumption of section 108(b) is inapplicable to sham transactions devoid of economic substance, and thus cannot justify the deductions.

We agree. If a transaction is devoid of economic substance — as the transactions involved here undeniably were —, it simply is not recognized for federal taxation purposes, for better or for worse. This denial of recognition means that a sham transaction, devoid of economic substance, cannot

be the basis for a deductible "loss." Section 108, then, which allows deductions for *losses* incurred pursuant to straddle transactions, is inapplicable to straddle transactions devoid of economic substance as there is no "loss" to which the presumption provided by section 108 can apply.

The Tax Court had jurisdiction pursuant to I.R.C. §§ 6214(a), 7442. We have jurisdiction to review final decisions of the Tax Court pursuant to 28 U.S.C. § 1291, and I.R.C. § 7482(a). Inasmuch as the appellants resided in New Jersey at the time of the filing of their respective petitions to the Tax Court, venue for these appeals lies in this court pursuant to I.R.C. § 7482(b)(1)(A). Timely notices of appeal were respectively filed by the taxpayers and the Commissioner.[1]

I.

Facts / Procedural History

The underlying facts of this case are essentially not in dispute. Each appellant claims to be a "commodities dealer" as that term is used in the Code,[2] and each seeks to deduct losses incurred as a result of dealings in option-straddle

---

1. The Commissioner, in appeals filed "for protective purposes only," asserts that if this court holds that the taxpayers are entitled to the deductions disallowed by the Tax Court, the appellants are required to offset their claimed losses with corresponding gains reported in the subsequent years of the transactions at issue. In light of our disposition, we do not reach the issue asserted by the Commissioner's appeals.

2. *See* I.R.C. § 1092 note (section 108(f)) (1988) (cross-referencing I.R.C. § 1402(i)(2)(B)); I.R.C. § 1402(i)(2)(B) (1988) (defining "commodities dealer"). Appellants' spouses are parties to these proceedings only by virtue of the filing of joint tax returns. *Fox v. Comm'r*, 56 T.C.M. at 865.

BEST AVA

transactions engaged in through brokers operating on the London Metal Exchange in 1975, 1976 and 1977.[3] In a prior, unrelated case, *Glass v. Comm'r*, 87 T.C. 1087 (1986), which we discuss in further detail *infra*, the Tax Court held that the London option-straddle transactions are shams, lacking in economic substance. The petitioners in *Glass* were therefore denied the deductions they claimed as "losses" incurred from the transactions. 87 T.C. at 1177. Significantly, however, the *Glass* court stated that, "[t]he case before us does not involve commodities dealers." *Id.* at 1167.

The parties here stipulated that the "London options transactions at issue in this case are of the same type as those described by the Court in *Glass et al. v. Commissioner*, 87 T.C. No. 68 (Nov. 17, 1986) in the Court's Findings of Fact, Section III A." They thus agree, *per Glass*, that the transactions in this case were shams, lacking economic substance. Appellants nonetheless moved before the Tax Court for summary judgment, arguing that as commodities dealers

---

3. Title V of the Economic Recovery Tax Act of 1981 ("ERTA") essentially eliminated the tax benefits of straddle transactions. *See* I.R.C. §§ 1256, 1092 (1988). Essentially, these provisions provide that: (1) regulated futures contracts held by the taxpayer at the close of the year are treated as having been sold on the last business day of the taxable year, with any resulting gain or loss recognized for tax purposes; and (2) losses from other commodity straddles will be recognized only to the extent that such losses exceed unrealized gain on the offsetting position of the straddle. *See Miller v. Comm'r*, 836 F.2d 1274, 1276 n.1 (10th Cir. 1988). By forcing a year-end framework on the straddle transactions, ERTA prevents the two-year period required by straddles to create apparent losses. We discuss the workings of the straddle transactions in further detail *infra*.

LABLE COPY

they should be permitted to deduct the losses pursuant to section 108(b). Appellants contended that, because they are commodities dealers, under section 108(b) they are presumed to have incurred the straddle-generated losses in a trade or business, and that the transactions in which they engaged therefore cannot be classified as shams devoid of economic substance. They argued that their case was distinguishable from *Glass*, which did not involve commodities dealers. The Commissioner, however, refused to concede that appellants were dealers and the Tax Court held that "[w]e are unable to establish from the stipulated facts that petitioners were 'person[s] who [were] actively engaged in trading [I.R.C. §] 1256 contracts and [were] registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission' during the years at issue." 56 T.C.M. at 866. *See* n.2 *ante*. Since the appellants' commodities dealer status remained in dispute, and since their entitlement to the presumption provided by section 108 revolved around this controverted issue of material fact, the Tax Court denied their summary judgment motion, a disposition not before us on appeal. 56 T.C.M. at 867.

The Commissioner cross-moved for summary judgment on the basis that, as a matter of law, even if the appellants were commodities dealers they were not entitled to the deductions. Relying on its opinion in *Glass* for the proposition that the London option-straddle transactions were devoid of economic substance, and on its opinion in *Cook v. Comm'r*, 90 T.C. 975 (1988), *aff'd*, 931 F.2d 59 (9th Cir. 1991) (table), holding that since the

London option-straddle transactions are economic shams devoid of substance even commodities dealers may not take deductions based on losses sustained in the transactions, the Tax Court granted the Commissioner's motion. The court held that, as a matter of law, even if appellants are commodities dealers, the London option-straddle transactions are shams, 56 T.C.M. at 869, and that since the transactions therefore lack economic substance, they produce no "loss" to which section 108 could apply. *Id.*

The Tax Court based its summary judgment on a legal determination regarding the construction of section 108 and thus our review is plenary. *See Pleasant Summit Land Corp. v. Comm'r*, 863 F.2d 263, 268 (3d Cir. 1988), *cert. denied*, 110 S.Ct. 260 (1989); *Casper v. Comm'r*, 805 F.2d 902, 904 (10th Cir. 1986) (Tax Court's decision to grant summary judgment is legal determination reviewable *de novo* by court of appeals). As the Commissioner was the prevailing party in the Tax Court, we resolve all controverted issues of material fact in favor of the appellants and accordingly, like the Tax Court, for the purposes of this appeal we assume that they are commodities dealers.

II.

The London Option-Straddle Transactions[4]

The London Metal Exchange is a commodity exchange on which cash, futures, and option

4. The following description is culled primarily from *Glass*, and is included in an attempt to make the transactions at issue understandable. *See Glass v. Comm'r*, 87 T.C. at 1095-1106.

contracts in silver, copper, zinc, tin, and lead are traded. Unlike its counterparts in the United States, such as the Chicago Board Options Exchange, the Exchange does not operate as a clearing house for trades. Rather, all transactions on or subject to Exchange rules are executed on a principal-to-principal basis, meaning that a person purchasing an option or futures contract through a broker/dealer, purchases that contract from the broker/dealer. The broker/dealer does not operate simply as an agent for a third party.

A person can trade on the Exchange in options or futures or both. The three most common forms of options are call, put, and double options. A call option gives the holder/buyer the *right* to buy from the grantor/seller a specified quantity of a commodity at an agreed price at any time before the option's expiration date. A put option gives the holder the *right* to sell a specified quantity of a commodity at an agreed price to the grantor at any time before the option's expiration date. A double option gives the holder the *right* either to sell or buy the underlying commodity at the agreed price before the option's expiration date. Under an option contract the holder has the *right* but not the obligation to purchase or sell the stated commodity at the agreed price and, accordingly, is never at risk for more than the cost of the option.

A futures contract *requires* the buyer to receive, and the seller to deliver, a specified quantity of a given commodity at some future date. Although a futures contract is legally binding between the parties, actual delivery of the underlying commodity rarely occurs. In traded futures and traded options, the contract is normally terminated ("closed out") before actual delivery by offsets, that

is, the execution of an equal and opposite transaction. *See DeMartino v. Comm'r*, 862 F.2d 400, 402 (2d Cir. 1988).

A "straddle" is the simultaneous holding of a contract to buy and a contract to sell the same commodity. *Kirchman v. Comm'r*, 862 F.2d 1486, 1488 (11th Cir. 1989). It consists of the simultaneous holding of a "long position" (a purchased contract) of a commodity for delivery in a future month, and a "short position" (a sold contract) for the identical amount of the same commodity for delivery in a different future month. Each contract is called the "leg" of the straddle. A straddle may be established (or "put on") using either option or future contracts or a combination of both. A "switch" occurs when the holder of a straddle liquidates (*i.e.*, closes out) one leg of the straddle and replaces it by either purchasing or selling (depending on which leg was closed out) an identical quantity of the same commodity for delivery in a different month.

The potential for profit from a straddle derives from changes in the price differential between the legs of the straddle. A straddle in which the long position is held in a month farther out than the short position increases in value if the price differential between the legs widens, and decreases in value if the price differential narrows. Conversely, a straddle in which the short position is held in a month farther out than the long position increases in value if the price differential narrows, and decreases in value if the price differential widens.

On the Exchange, the more common transaction strategy involved what is called the option-straddle

transaction. The option-straddle strategy was based on the use of both option and futures contracts.

The typical London option transaction involved a two-year series of trades in options and futures designed to create losses in the first year and nearly offsetting gains in the second year. In the first year, the following combination of trades was initiated:

(1) an option-straddle was established, consisting of the simultaneous purchase and sale of either a call or put option, or both, for identical quantities of the same commodity with different delivery dates; and

(2) a futures straddle was also established, consisting of the simultaneous purchase and sale of futures contracts for identical quantities of the same commodity with different delivery dates.

Shortly after the option-straddle was established, the legs would be closed out through the purchase and sale of identical offsetting positions. If a call option was purchased, the dealer would sell an identical put option; vice versa for a put option. Because this second set of option contracts would be purchased and sold on a different date than the original option contracts, the prices of the contracts would differ. The result would be that in closing out one leg of the option straddle, the taxpayer would incur a loss, and in closing out the other leg, the taxpayer would incur an approximately equal gain. The loss realized would be deducted as ordinary loss under I.R.C. § 165(c)(2) and offset income from other unrelated sources. The gain would be a short-term capital gain. *See Kirchman*, 862 F.2d at 1488.

Next, to defer recognition of the gain, the "loss" leg of the futures straddle would be closed out in a "switch transaction" through the purchase (or sale) of an identical offsetting position and replaced by a new position with a different delivery date. The net loss on the closed leg of the futures straddle would be reported as a short-term capital loss in the first year and would approximately equal the short-term capital gain incurred in closing out the option position described above. This capital loss would offset the capital gain.

The final step of a typical option-straddle transaction occurred in the subsequent year, although not earlier than six months after the switch. Both legs of the futures straddle would be closed out by offsetting trades, resulting in a gain approximately equal to the loss incurred on the switch in the previous year. The gain incurred would be reported as either short-term or long-term capital gain in the second year of the transaction. Many participants attempted to defer or convert this second-year gain by engaging in a rollover transaction, which meant putting on another futures straddle in the second year of the transaction, subsequently closing out the loss leg in a switch and then closing out the straddle at a gain in the third year. The net general objective of these transactions was the realization of ordinary loss in the first year, and the deferral of capital gain, short- or long-term, to the second year. While paper "losses" were substantial for tax purposes in year-one, ultimate actual losses, if any — and actual gains, if any —, were small by comparison.

III.

The Glass Decision and Section 108

Glass v. Comm'r, 87 T.C. 1087,[5] involved aggregate deficiencies determined by the Commissioner against over 1000 taxpayers totalling in excess of $61 million for the years 1975-1980. The transactions involved the "London option-straddle transaction," and were all virtually identical to the transactions described above. There were two issues before the Tax Court in *Glass*: (1) whether the transactions were shams; and (2) if not, whether the transactions were entered into for profit under the standard set forth in section 108. 87 T.C. at 1091.

The Tax Court in *Glass* found that the London option transaction was without economic substance and was a sham.[6] *Id.* at 1177. It

---

5. *Glass* has been affirmed by every circuit court of appeals to which it has been appealed. *Lee v. Comm'r*, 897 F.2d 915 (8th Cir. 1989); *Kielmar v. Comm'r*, 884 F.2d 959 (7th Cir. 1989); *Dewees v. Comm'r*, 870 F.2d 21 (1st Cir. 1989); *Friedman v. Comm'r*, 869 F.2d 785 (4th Cir. 1989); *Keane v. Comm'r*, 865 F.2d 1088 (9th Cir. 1989); *Ratliff v. Comm'r*, 865 F.2d 97 (6th Cir. 1989); *Killingsworth v. Comm'r*, 864 F.2d 1214 (5th Cir. 1989); *Kirchman v. Comm'r*, 862 F.2d 1486 (11th Cir. 1989); *Yosha v. Comm'r*, 861 F.2d 494 (7th Cir. 1988); *Herrington v. Comm'r*, 854 F.2d 755 (5th Cir. 1988), *cert. denied*, 490 U.S. 1065, 109 S.Ct. 2062 (1989).

6. An economic sham is distinguished from a factual sham. A factual sham is one in which the alleged transactions never actually took place. In an economic sham, or a sham in substance, the alleged transactions actually took place, but are nonetheless without economic substance. The Tax Court has defined "sham in substance" as the "expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits." *Falsetti v. Comm'r*, 85 T.C. 332,

therefore determined that the transaction and loss deductions taken pursuant thereto must be disregarded for federal income tax purposes. *Id.* The Tax Court analyzed the entire two-year scheme in detail and concluded that the transactions were "intentional[ly] skew[ed]. . . to realize year one losses. . . ." *Id.* at 1174. The potential for a profit existed but the taxpayers avoided making a profit by intentionally realizing losses in the first year

---

347 (1985). The Court of Appeals for the Ninth Circuit has defined a transaction as a sham in substance if it is fictitious or if it has no business purpose or economic effect other than the creation of tax losses. *Sochin v. Comm'r*, 843 F.2d 351, 354 (9th Cir.), *cert. denied*, 488 U.S. 824, 109 S.Ct. 72 (1988). *See also Friedman v. Comm'r*, 869 F.2d 785, 792 (4th Cir. 1989) (same). The Court of Appeals for the Eleventh Circuit has stated that a transaction with the sole function of the production of tax deductions is a sham regardless of the taxpayer's motives. *Kirchman v. Comm'r*, 862 F.2d 1486, 1491 (11th Cir. 1989).

As characterized by at least one court, the economic substance requirement is a sub-test for a sham transaction. That is, there is a two-part test of whether a transaction constitutes a sham. Under this test, a transaction is a sham if: (1) it is not motivated by any economic purpose outside of tax considerations; and (2) it is without economic substance because no real potential for profit exists. *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 91 (4th Cir. 1985) (interpreting sham transaction doctrine of *Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S.Ct. 1291 (1978)).

In the case before this court, the London option transactions were found by the Tax Court to be shams and without economic substance – indeed, the parties essentially stipulated to this finding. Although this characterization may be repetitive, the Tax Court's determination that the transactions involved were shams has been uniformly upheld on appeal. *See, e.g., Lee*, 897 F.2d at 915; *Dewees*, 870 F.2d at 21; *Friedman*, 869 F.2d at 785; *Keane*, 865 F.2d at 1088; *Ratliff*, 865 F.2d at 97; *Kirchman*, 862 F.2d at 1486.

which "were not necessary or helpful in profiting from difference gains in petitioners' commodity straddle transactions." *Id.* at 1175-76. Based on its determination that the London options transactions lacked economic substance and were shams, the Tax Court further held that section 108 was "not available to permit loss deductions in the first year of commodity straddle transactions when, as here, the sham involves a series of transactions having no business or profit-making function apart from obtaining tax deductions." *Id.* at 1176.

The Tax Court in *Glass* rejected the taxpayers' argument that, since the tax effects to them of the transactions were sometimes adverse, the Commissioner's allegation that they paid for pre-arranged tax results was unfounded since it failed to account for the ability to offset in future years. The Tax Court found that "[i]t requires no lengthy or elaborate analysis of the facts to demonstrate that petitioners did not enter into these transactions primarily for economic profit," and that "[t]he expected tax benefits completely overwhelm[ed] any potential economic benefits that might have been expected from the straddles." *Id.* at 1162. "[P]etitioners hoped to obtain substantial interest-free loans from the government and achieve more favorable tax rates. At the same time the actual economic gains realized through straddling were either minuscule or non-existent." *Id.* at 1163.

During the course of the proceedings in *Glass*, but before decision was rendered, Congress enacted section 108 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 630, subsection *(a)* of which essentially provided that

losses from the disposition of a leg of a straddle entered into before 1982, were deductible if the straddle was entered into "for profit." Subsection *(b)* provided that straddle transactions of commodities dealers were rebuttably presumed to have been entered into for profit.[7] Section 108 was enacted as a response to the Commissioner's decision to challenge the deductibility of losses incurred in London option transactions, which resulted in an overwhelming amount of litigation. To deal with the backlog of straddle cases, in 1984 Congress passed section 108, with its for-profit presumption.[8]

---

7. Section 108 originally provided in part:

> TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.
>
> (a) GENERAL RULE — For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions —
>
> (1) which were entered into before 1982 and form part of a straddle, and
>
> (2) to which the amendments made by title V of the Economic Recovery Tax Act of 1981 do not apply,
>
> any loss from such disposition shall be allowed for the taxable year of the disposition *if such position is part of a transaction entered into for profit.*
>
> (b) PRESUMPTION THAT TRANSACTION ENTERED INTO FOR PROFIT. — For purposes of subsection (a), any position held by a commodities dealer or any person regularly engaged in investing in regulated futures contracts shall be rebuttably presumed to be part of a transaction entered into for profit.

Tax Reform Act of 1984, Pub. L. No. 98-369, § 108(b), 98 Stat. 630 (emphasis added).

8. This history of Section 108 is derived primarily from *Friedman v. Comm'r*, 869 F.2d at 789-91.

The Tax Court first applied the 1984 section 108 in *Miller v. Comm'r*, 84 T.C. 827 (1985). In *Miller*, the Commissioner argued that the phrase "transaction entered into for profit" used in section 108 was unambiguous, was intended to be interpreted identically to the exact same phrase as used in I.R.C. § 165(c), and transactions not entered into *primarily* for profit were therefore not entitled to a loss deduction. A divided Tax Court rejected this argument finding that the language of section 108 was "sufficiently ambiguous to warrant [a] search for interpretive assistance." 84 T.C. at 838. Relying on the legislative history of section 108, the Tax Court found that the phrase "transaction entered into for profit" as used in section 108, allowed deductions for loss when the taxpayer merely had a "reasonable expectation of any profit." Section 108 did not require that profit have been the primary motive for the transaction. *Id.* at 841-42.

The Tax Court's decision in *Miller*, however, was reversed. *Miller v. Comm'r*, 836 F.2d 1274 (10th Cir. 1988). The Court of Appeals for the Tenth Circuit held that section 108 incorporated the "primarily for profit" standard that has emerged as the settled case law of I.R.C. § 165(c)(2). Prior to the court of appeals' decision, however, and in direct response to the Tax Court's holding in *Miller*, Congress retroactively amended section 108 in section 1808(d) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2817. As amended, section 108(a) provides that losses attributable to the disposition of a leg of a commodity straddle are deductible if incurred in a trade or business *or* in a transaction entered into for profit. Section 108(b), in turn, provides an

irrebuttable presumption that losses incurred by a commodities dealer were incurred in a trade or business.[9] As explained by the Tax Court in *Glass*, amended section 108 traces the pattern of the loss provisions of I.R.C. §§ 165(c)(1) and (2),[10] and "makes it clear that losses incurred by commodities dealers trading in commodities are

---

9. As amended, Section 108 reads in part:

> TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.
>
> (a) GENERAL RULE. – For purposes of the International Revenue Code of 1954, in the case of any disposition of 1 or more positions –
>
> (1) which were entered into before 1982 and form part of a straddle, and
>
> (2) to which the amendments made by title V of the Economic Recovery Tax Act of 1981 do not apply,
>
> any loss from such disposition shall be allowed for the taxable year of the disposition *if such loss is incurred in a trade or business*, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business.
>
> (b) *LOSS INCURRED IN A TRADE OR BUSINESS*. – For purposes of subsection (a), *any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business*.

Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(d)(1) - (2), 100 Stat. 2817-18 (emphasis added).

10. Those sections relate to I.R.C. § 165(a), which provides:

> (a) General rule.– There shall be allowed as a deduction any loss sustained during the taxable year and not compensated by insurance or otherwise.

Sections 165(c)(1) and (2), I.R.C., in turn provide:

> (c) Limitation on losses of individuals.– In the case

deductible under section 108 since they are losses incurred in a trade or business." Non-dealer investors, on the other hand, must meet the test of loss incurred in a transaction entered into for profit. Thus, in *Glass*, rendering decision based on section 108 as retroactively amended, the Tax Court stated that the deductibility of straddle losses was to be determined by a "primarily for profit" standard. 87 T.C. at 1167.[11] "The case before us," said the court, "does not involve commodities dealers." *Glass*, 87 T.C. at 1167.

IV.

The Cook Decision

Subsequent to its decision in *Glass*, the Tax Court decided *Cook v. Comm'r*, 90 T.C. 975 (1988), *aff'd*, 931 F.2d 59 (9th Cir. 1991) (table). *Cook*

---

of an individual, the deduction under subsection (a) shall be limited to –

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business . . . .

11. *See also Dewees v. Comm'r*, 870 F.2d at 29 (Congress enacted section 108 to clarify the application of the general loss deduction rule of section 165 to straddle transactions because Congress wanted to make clear that taxpayers could take a straddle position loss in the year of disposition; prior to the enactment of section 108, the IRS had claimed that the sale of one leg of a straddle was not a closed and completed transaction under which the taxpayer could deduct losses – rather, the taxpayer had to dispose of the other leg to deduct losses under section 165(c)); *DeMartino*, 862 F.2d at 407 (section 108 was intended to overrule the sharply divided Tax Court's decision in *Miller* and to harmonize section 108 with section 165 of the Code).

involved a motion for reconsideration by one of the taxpayers in *Glass* based on a taxpayer's contention that he was in fact a commodities dealer during the tax years at issue in *Glass*. Therefore, according to the taxpayer, the *per se* rule under section 108(b) for commodities dealer losses incurred in a trade or business allowed him to take deductions for losses incurred in the London option transactions, 90 T.C. at 979. For purposes of his argument, the taxpayer conceded that his straddle transactions "lacked economic substance and were a sham in the economic sense," which the Tax Court noted was "consistent with [its] holding in *Glass*." *Id.* at 980.

The *Cook* petitioner's position was, of course, virtually identical to that of the appellants in that both rest on section 108(b). Thus, in this case, the appellants contend as did the petitioner in *Cook*, that a commodities dealer, as a matter of law, is entitled to the deductions for losses on the Exchange because under section 108(b), losses incurred by a commodities dealer in straddle transactions are irrebuttably presumed to have been incurred in a trade or business and under section 108(a) are allowable deductions. *See* 90 T.C. at 979.

The Commissioner's position in *Cook* was identical to the position he takes before this court. The Commissioner argued there that section 108(b) is not applicable to sustain loss deductions claimed from the London option transactions because the transactions were shams in substance, prearranged solely to achieve a tax-avoidance objective. As such, section 108(a) does not apply in determining whether the losses were allowable. Because section 108(a) does not

apply, section 108(b) and its presumption do not come into play. Put another way, the Commissioner argued – and again argues here – that when a transaction lacks economic substance, there is, in the legal sense, no *loss* for purposes of section 108(a), and the presumption of section 108(b), therefore, simply does not apply.

In *Cook*, the Tax Court conceded that its statement in *Glass* that the case did not involve commodities dealers was "inaccurate" at least as to Cook. The Tax Court nonetheless did not allow his deductions. It held that, even as to commodities dealers, "it is appropriate before applying the per se rule of section 108(b) to enquire whether straddle transactions were fictitious, prearranged, or otherwise in violation of the rules of the exchange, and if so, whether there were losses actually incurred." 90 T.C. at 986. *See also id.* n.6. Since the London option transactions were unquestionably prearranged to generate a loss, reasoned the court, the *per se* rule of section 108(b) was unavailable to Cook.

In reaching its determination in *Cook*, the Tax Court considered it appropriate to consider the legislative history surrounding section 108(b) which "expressly provides a caveat to the per se rule." 90 T.C. at 984. The House Report regarding amended section 108(b) states that the section 108(b) "presumption would not be available in any cases where the trades were fictitious, *prearranged*, or otherwise in violation of the rules of the exchange in which the dealer is a member." H.R. Rep. 426, 99th Cong., 1st Sess. 911 (1985) (emphasis added).

The Tax Court stated that the "prearranged" language of the Report "casts a shadow on the

otherwise bright line parameters of the per se rule." 90 T.C. at 985. Based on the language in the House Report, the Tax Court determined that, where the losses are prearranged, the issue arises whether the losses were actually incurred, which is a necessary precondition to the application of the *per se* rule. The Tax Court reiterated its finding in *Glass* that the losses putatively incurred were lacking in economic substance and therefore were shams. "In effect, then, no losses were incurred." Thus, the *per se* dealer rule is not available since section 108(b) only applies to "any loss" incurred by a commodities dealer. *Id.* at 985. The Tax Court further noted that "we think it would be highly anomalous to disallow loss deductions to over 1,000 petitioners claiming them under the London Option Transaction, as we have done in *Glass*, while allowing them to petitioner, even though a dealer, on the self-same transaction." *Id.* at 985. Accordingly, the holding in *Cook* stands for the proposition that the *per se* dealer rule will be unavailable not only in situations involving fictitious transactions but will also be unavailable to dealers involved in actual transactions, "prearranged" to lack economic substance.

V.

Glass, Cook, and Section 108 As Applied To This Case

Appellants' basic position before this court is that section 108(b) was intended to treat dealers as a favored class and to make the "profit motive" test inapplicable to them. They argue that section 108(b) allows them to deduct losses incurred pursuant to straddle transactions, *even if those transactions are unquestionably economic shams.*

Accordingly, if dealers incur losses in transactions designed solely to generate tax losses, they are nonetheless deductible because section 108(b) precludes the Commissioner from challenging dealers' profit motive.

The legislative history to section 108 as amended allegedly reflects a congressional intent in accord with this position. Appellants claim that section 108 was originally enacted in a congressional effort to "break the log jam" of cases in which the Commissioner challenged loss deductions based on options or future straddle transactions.[12] The amendments to section 108, particularly the addition of the irrebuttable presumption regarding commodities dealers in subsection (b), are said to reflect a congressional intent to give commodities dealers special treatment regarding straddle transactions. According to appellants, the amendment to section 108 was intended, and is understood, to have given straddle-loss-deduction amnesty to everyone engaged in the commodities trading business. Thus, appellants urge this court to hold that section 108(b) applies to provide an irrebuttable presumption that losses stemming from straddle transactions engaged in by dealers before 1982 are deductible even though such transactions were designed solely to create tax losses. We decline to accept this invitation.

Per Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266 (1935), it is settled federal tax law that for transactions to be recognized for tax purposes they must have economic substance. Therefore,

---

12. By one estimate, at least 4,400 straddle cases were pending before the Tax Court in the early 1980's. *Miller*, 84 T.C. at 855. There were over 1,400 original petitioners in *Glass* alone. *Glass*, 87 T.C. 1087-90.

economic substance is a *prerequisite* to the application of any Code provisions allowing deductions, including section 108.

The London option transactions involved lacked economic substance because they were prearranged transactions intended solely to generate tax benefits in the form of deductible losses. Thus, as they lacked economic substance, they cannot be recognized for tax purposes. Because they are not recognized for tax purposes, section 108 does not even come into play. Section 108(b) applies to "any loss" deducted under section 108(a), but section 108(a) cannot be applied to transactions lacking in economic substance because, in tax terms, a transaction lacking in economic substance cannot result in a "loss." The option-straddles in this case, then, lacking economic substance and therefore non-recognizable for tax purposes, produced no "losses" to which section 108(a) can apply, thus precluding any application of section 108(b).

We agree that the irrebuttable presumption in amended section 108(b) was intended to, and did, eliminate any profit motive inquiry for straddle transactions as to dealers. We agree also that this amendment reflected Congress' concern with the inherent difficulty in determining a dealer's profit motive with respect to any particular trade because a dealer is involved in so many trades. Amended section 108(b), therefore, was enacted to avoid this difficulty. Thus, section 108(b) prevents the Commissioner from disallowing loss deductions by pointing to evidence that any one dealer did not have a profit motive when engaging in a straddle transaction.

We see no basis to hold, however, that the amendment to section 108(b) was intended to

override the long-standing requirement that transactions have economic substance to be qualified for loss deduction status. *See DeMartino*, 862 F.2d at 407; *Cook*, 90 T.C. at 984-85. As explained in *DeMartino*, elimination of a profit motive inquiry does not "prevent the inquiry into the economic substance of a dealer's commodity trading." The Tax Court and numerous appellate courts have held that section 108 does *not* apply to sham commodity transactions devoid of economic substance. *See, e.g., Glass*, 87 T.C. at 1176; *Keane*, 865 F.2d at 1093; *Sochin*, 843 F.2d at 353-54 n.6. The fact that such a transaction involves a commodities dealer is neither a logical nor a statutorily-authorized reason to alter the economic substance rule.

For instance, in *DeMartino v. Comm'r*, 862 F.2d at 400, the taxpayer, a commodities trader, invested in crude oil future straddles executed on the New York Cotton Exchange, a regulated American exchange. The market in crude oil futures was extremely thin and the brokers were able effectively to control the contract prices. They executed these contracts in a prearranged plan designed to create tax losses without any real possibility of gain or loss. The Commissioner assessed deficiencies which the Tax Court upheld, finding that the transactions were shams and that the losses sustained therein could not be recognized for federal tax purposes. 862 F.2d at 404. On appeal, the taxpayer claimed that he was entitled to the deductions under section 108(b) since he was a dealer. The taxpayer claimed that since his trades were not factual shams, but were cleared through a regulated American exchange, they had economic substance and, even if they did

not have economic substance, section 108(b) applied to allow the deductions.

The court of appeals rejected this argument. The court first held that, even though the trades were cleared on a regulated American exchange, they lacked economic substance because they were prearranged to result in nothing more than tax losses. 862 F.2d at 406. The court then rejected the argument that section 108(b) nonetheless entitled the taxpayer/dealer to the deductions. The court stated that in enacting section 108(b):

> Congress eliminated the profit motive inquiry in cases involving dealers because of the inherent difficulty involved in making such an inquiry, *but it did not prevent inquiry into the economic substance of a dealer's commodity trading.*

862 F.2d at 407 (emphasis added).

The court further stated that section 108(a) does not apply to straddle transactions that are shams and since section 108(a) cannot apply to sham transactions, section 108(b) does not apply. The court defined a sham as a transaction that "is fictitious or . . . has no business purpose or economic effect other than the creation of tax deductions." *Id.* at 406.[13]

---

13. Appellants claim that *DeMartino* is distinguishable from this case because it involved transactions that were factual, rather than economic, shams. In essence, they argue that section 108(b) would be unavailable to sustain deductions on transactions that never actually occurred, but as long as the trades do in fact occur, even if prearranged to create tax losses, section 108(b) allows dealers to take deductions based on them. This attempt to distinguish *DeMartino* is faulty, for in *DeMartino*, the trades *did* actually occur but were devoid of economic substance because they were designed solely to create losses. 806 F.2d at 406.

And quite recently, in *Cook v. Comm'r*, 90 T.C. 975, the Tax Court held specifically that even as to commodities dealers involved in the London option transactions, the presumption provided by section 108(b) is not available where the transactions are devoid of economic substance. As discussed above, the Tax Court held that, even as to commodities dealers, before applying section 108(b), a straddle transaction must have economic substance. *Id.* at 986. The Tax Court found that since the London option transaction was "deliberately prearranged," section 108(b) was unavailable to sustain the petitioner's deductions. *Id.*

The Tax Court considered the legislative history surrounding section 108(b) and particularly focused on the language in the House Report noted above which states that the section 108(b) "presumption would not be available in any cases where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member." H.R. Rep. No. 426, 99th Cong, 1st Sess. 911 (1985). The presumption in section 108(b), then, absolves dealers of the need to prove any profit motive so long as the transactions involved are not fictitious, *prearranged*, or otherwise in violation of the exchange's rules. 90 T.C. at 985-86.

Based on this language, the *Cook* court determined that, where the losses are prearranged they are non-recognizable for tax purposes. Such non-recognizable losses lack economic substance and are therefore shams. In essence, losses pursuant to sham transactions are not losses for tax purposes. Therefore, the *per se* dealer rule is not available to sustain deductions based on the

alleged losses since section 108(b) only applies to "any *loss*" incurred by a commodities dealer – and any "*loss*" must be an *actual* loss.

We accept the reasoning in *DeMartino* and *Cook*, there being no principled distinction between them and the present case as to facts or legal consequences. The basic rule of law is that taxation is based upon substance, not form. *Gregory*, 293 U.S. at 469-70, 55 S.Ct. at 267-68. The holdings in *DeMartino* and *Cook*, and the position taken by the Commissioner in this case are in accord with that rule. The result urged on this court by appellants would allow a small group of taxpayers – commodities dealers who engaged in sham straddle transactions before 1982 – to claim "losses" when none in fact were sustained. We do not believe Congress intended this unseemly result, which would undermine the power and duty of the Commissioner and the courts to look beyond the mere forms of transactions to their economic substance and to apply the tax laws accordingly. *Forseth v. Comm'r*, 845 F.2d 746, 749 (7th Cir. 1988).

The economic substance doctrine has been consistently applied by the courts for many years in a variety of tax situations. There is no sound reason to conclude that, in enacting the amendments to section 108(b), Congress meant to abandon the doctrine. *See, e.g., Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S.Ct. 1291 (1978) (court looked at economic substance or reality of sale and leaseback transactions); *Knetsch v. United States*, 364 U.S. 361, 81 S.Ct. 132 (1960) (interest expense deductions disallowed because only thing of substance to be realized from transaction was tax deduction); *Commissioner v. Court Holding Co.*,

324 U.S. 331, 65 S.Ct. 707 (1945) (recognizing step transaction doctrine, whereby courts must consider all steps of transaction in light of entire transaction, so that substance of transaction will control over form of each step).

In essence, the appellants would have this court find that, because of a backlog in the court system, Congress abandoned the economic substance requirement as to straddle transactions involving dealers, along with some 40 years of jurisprudence regarding the economic substance doctrine, and instead gave these sham transactions post-facto blessing. This is an unreasonable conclusion, and one which as a basic tenet of statutory interpretation should not be reached. *See Dewees*, 870 F.2d at 35-36 (it is unreasonable to believe that Congress in enacting section 108 wished to weaken the sham in substance doctrine). *See also Haggar Co. v. Helvering*, 308 U.S. 389, 394, 60 S.Ct. 337, 339-40 (1940). If Congress had intended to grant such a windfall it could and, one must assume, would have done so in a manner free from any doubt or ambiguity.

Faced with overwhelming and well-reasoned case law, *see, e.g.*, n.15 *infra*, and less than unambiguous statutory authority, the appellants nonetheless contend that section 108(b) does apply to sustain their sham transaction deductions. They urge that the legislative history of section 108 proves that Congress, in creating the irrebuttable presumption of profit-motives for dealers, intended to allow dealers to deduct losses pursuant to sham transactions such as those involved in this case. According to the appellants, Congress clearly intended to sacrifice the tax revenue which would

be received pursuant to disallowing deductions sought by dealers in its desire to clear the Tax Court's docket of cases involving straddle transactions. In its attempt to do so, it amended section 108(b) to remove the profit motive requirement as to dealers because of the inherent difficulty in determining the existence or lack thereof of profit motive for dealers in numerous individual transactions. That is, for expediency's sake, Congress gave dealers unique treatment as far as pre-1982 straddle transactions, granting them an unquestionable right to deduct losses based on straddle transactions, in an effort to clear the docket of these cases.

Although the legislative history of section 108 does reveal congressional concern with the logjam of straddle cases before the Tax Court, the idea that Congress intended to grant dealers the right to deduct losses pursuant to sham transactions is unpersuasive. Both the 1984 and 1986 versions of section 108(b) reflect congressional recognition that dealers conduct numerous trades, as a result of which there is an "inherent difficulty in distinguishing tax-motivated straddle transactions from profit-motivated straddle transactions . . . ." H.R. Rep. No. 426, 99th Cong., 1st Sess. at 910-11 (1985). Thus, it is quite possible that in amending section 108(b), Congress was willing to give up a certain amount of revenue from straddle transactions because it recognized the inherent difficulty in proving a dealer's subjective profit motive as to any one transaction. This, however, is a far cry from saying that Congress intended to allow dealers to take deductions based on straddle transactions totally devoid of any purpose beyond the generation of tax deductions and passed a

statute by which there would be absolutely no inquiry into the substantial tax validity of such transactions.

The much more logical conclusion is that reached by the court of appeals in *DeMartino* — *viz.* that section 108 eliminated the profit motive inquiry in cases involving dealers because of the inherent difficulty in making such an inquiry, but it did not prevent inquiry into the economic substance of a dealer's commodities trading. 862 F.2d at 407. There is ample support for this proposition. *See Knetsch v. United States*, 364 U.S. at 365, 81 S.Ct. at 134-35 (Court put aside district court's finding concerning motive in determining whether a transaction was a sham); *Forseth*, 845 F.2d at 748 (if a transaction is a sham, then such "niceties" as whether it was primarily for profit are not involved); *Kirchman*, 862 F.2d at 1492 (once a court determines that a transaction is a sham, no further inquiry into intent is necessary); *Dewees*, 870 F.2d at 35 (a taxpayer cannot deduct a sham transaction loss, irrespective of his subjective profit motive).[14] Furthermore, we see no internal inconsistency in the *DeMartino* conclusion as it

---

14. In their reply brief to this court, appellants claim that the Supreme Court recently held in *Cottage Savings Ass'n v. Comm'r*, U.S. , 111 S. Ct. 1519 (1991), that "transactions will not be denied effect as wanting in economic substance if the transactions are bona fide." They argue that since the transactions here actually occurred, they were bona fide and cannot be found wanting in economic substance. This argument mischaracterizes the holding in *Cottage* and has no merit in this case. In *Cottage*, the Court rejected the Commissioner's argument that the transactions at issue lacked economic substance and therefore could not sustain the deductions taken. There the transactions involved the exchange by a financial institution of its interests in one

BEST AVAI

does not follow that Congress by restraining one inquiry intended that a conclusion on another point must follow.

Finally, although the majority of the cases construing the London option transactions did not involve commodities dealers, a number of them do involve section 108 in general. These cases have uniformly held that when a transaction is a sham, it is outside the purview of section 108. Since the application of section 108*(b)* depends on the availability of section 108*(a)*, the fact that this case involves commodities dealers is not sufficient to distinguish it from the overwhelming majority of cases which have found section 108 unavailable to the London option transactions.[15] These cases

---

group of residential mortgages for another lender's interests in a different group of residential mortgages. The mortgages given over had a face value of some $2 million more than the fair market value of those received, based on which the petitioner took a loss deduction. As relevant to this case, the Court rejected the Commissioner's contention that the losses could not be sustained because they lacked economic substance because the Commissioner failed to meet its burden of proof on this claim. That is, the Commissioner relied on a case in which a finding of lack of economic substance was based on the determination that the transaction was not conducted at arm's length and because the taxpayer never relinquished control over the securities on which he based his deduction. The Commissioner in *Cottage* failed in any regard to contend or prove that the exchange involved was not at arm's length or that Cottage did not actually gave up control over the mortgages it exchanged. Therefore, the Court rejected the Commissioner's claim that the transaction lacked economic substance. *Cottage* cannot be read for the proposition that, as long as a transaction is bona fide, *i.e.*, actually occurred, it cannot be denied economic substance.

15. *See, e.g., Lee v. Comm'r*, 897 F.2d 915, 917 (8th Cir. 1989) ("[t]he London option transactions . . . lacked economic substance. As such, they are outside the purview of . . .

LABLE COPY

confirm our belief that Congress did not enact section 108(b) as a safe harbor for commodities dealers who engage in transactions devoid of economic substance, prearranged to create losses. In essence, the problem with the appellants' case is that they were really trading tax consequences rather than silver.

VI.

Conclusion

The Tax Court correctly determined that the option-straddle transactions at issue in this case are shams, devoid of economic substance, and thus any losses generated thereby cannot be the basis for deductions. Section 108(a), which allows *loss* deductions for straddle transactions, does not apply to countenance deductions for a sham transaction from which no true "loss" occurs, and the trade-or-business-loss presumption of section 108(b) cannot be claimed by commodities dealers unless they have sustained an actual loss. Therefore, we will affirm the decisions of the Tax Court and will dismiss the appeals of the Commissioner.

[section] 108 . . ."); *Friedman v. Comm'r*, 869 F.2d at 791 (section 108 is inapplicable to transactions constituting economic shams); *Keane v. Comm'r*, 865 F.2d at 1092-93 (because the London option transactions had no economic substance, section 108 did not apply); *Kirchman v. Comm'r*, 862 F.2d at 1494 (since the transaction as a whole, not just the first year losses, were designed solely to produce tax benefits, the transaction was a sham in substance and section 108 does not apply); *Sochin v. Comm'r*, 843 F.2d at 353-54, n.6 (section 108 does not apply until the court determines that the transaction is not a sham); *Enrici v. Comm'r*, 813 F.2d 293, 295, n.1. (9th Cir. 1987) (same); *Mahoney v. Comm'r*, 808 F.2d 1219, 1220 (6th Cir. 1987) (same); *Glass*, 87 T.C. at 1176 (section 108 unavailable to permit loss deductions in year one of sham transaction).

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

Supreme Court, U.S.
FILED
APR 14 1992
OFFICE OF THE CLERK

(2)

No. 91-1368

In the Supreme Court of the United States

OCTOBER TERM, 1991

CHARLES H. FALK AND JOAN FALK AND
HILARY P. GARDNER AND JUDITH C. GARDNER,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

KENNETH W. STARR
Solicitor General

JAMES A. BRUTON
Acting Assistant Attorney General

KENNETH L. GREENE
KIMBERLY S. STANLEY
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 514-2217

17

QUESTIONS PRESENTED

1. Whether the Tax Court has jurisdiction to apply the doctrine of equitable recoupment.

2. Whether the courts below properly declined to apply the doctrine of equitable estoppel against the government in the instant case.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	4
Conclusion	11

TABLE OF AUTHORITIES

Cases:

Bohrer v. *Commissioner*, 945 F.2d 344 (10th Cir. 1991)	2
Bull v. *United States*, 295 U.S. 247 (1935)	7
Burnet v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931)	9
Commissioner v. *Gooch Milling & Elevator Co.*, 320 U.S. 418 (1943)	5, 6
Commisisoner v. *McCoy*, 484 U.S. 3 (1987)	5
Continental Equities, Inc. v. *Commissioner*, 551 F.2d 74 (5th Cir. 1977)	6
Dewees v. *Commissioner*, 870 F.2d 21 (1st Cir. 1989)	2
Elbert v. *Johnson*, 164 F.2d 421 (2d Cir. 1947)	
Estate of Schneider v. *Commissioner*, 93 T.C. 568 (1989)	6
Federal Crop Ins. Corp. v. *Merrill*, 332 U.S. 380 (1947)	10
Fox v. *Commissioner*, 56 T.C.M. (CCH) 863 (1988), aff'd, 939 F.2d 44 (3d Cir.), cert. denied, 112 S. Ct. 590 (1991)	
Friedman v. *Commissioner*, 869 F.2d 785 (4th Cir. 1989)	2
Gardner v. *Commissioner*, 954 F.2d 836 (2d Cir. 1992)	
Glass v. *Commissioner*, 87 T.C. 1087 (1986)	2
Heckler v. *Community Health Services of Crawford County, Inc.*, 467 U.S. 51 (1984)	10

Cases—Continued: Page

Hillsboro Nat'l Bank v. *Commissioner*, 460 U.S. 370 (1983) 9
Kazi v. *Commissioner*, 61 T.C.M. (CCH) 1759 (1991) 4
Keane v. *Commissioner*, 865 F.2d 1088 (9th Cir. 1989) 2
Kielmar v. *Commissioner*, 884 F.2d 959 (7th Cir. 1989) 2
Killingsworth v. *Commissioner*, 864 F.2d 1214 (5th Cir. 1989) 2
Kirchman v. *Commissioner*, 862 F.2d 1486 (11th Cir. 1989) 2
Knapp v. *Commissioner*, 867 F.2d 749 (2d Cir. 1989) 5
Landreth v. *Commissioner*, 859 F.2d 643 (9th Cir. 1988) 9
Lee v. *Commissioner*, 897 F.2d 915 (8th Cir. 1989) .. 2
Lerman v. *Commissioner*, 939 F.2d 44 (3d Cir.), cert. denied, 112 S. Ct. 590 (1991) 3
Lone Manor Farms, Inc. v. *Commissioner*, 61 T.C. 436 (1974), aff'd, 510 F.2d 970 (3d Cir. 1975) 8
Massey v. *Commissioner*, 950 F.2d 723 (3d Cir. 1991), petition for cert. pending, No. 91-1369 4
OPM v. *Richmond*, 110 S. Ct. 2465 (1990) 10
Phillips Petroleum Co. v. *Commissioner*, 92 T.C. 885 (1989) 5, 6-7
Ratliff v. *Commissioner*, 865 F.2d 97 (6th Cir. 1989) 2
Rothensies v. *Electric Storage Battery Co.*, 329 U.S. 296 (1946) 6
Stone v. *White*, 301 U.S. 532 (1938) 7
United States v. *Dalm*, 494 U.S. 596 (1990) 5, 7, 9
Yosha v. *Commissioner*, 861 F.2d 494 (7th Cir. 1988) 2

Statutes and rule:

Internal Revenue Code of 1939, 26 U.S.C. 272(g) (1952) 5, 9
Internal Revenue Code of 1954 (26 U.S.C.):
§§ 1311 *et seq.* 9
§ 6214(b) 5, 8, 9

Statutes and rule—Continued: Page

Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 630:
§ 108, 98 Stat. 630-631 3
§ 108(a), 98 Stat. 630 3
§ 108(b), 98 Stat. 630 3
Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(d), 100 Stat. 2817-2818 3
Tax Ct. R. 155 3

In the Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-1368

CHARLES H. FALK AND JOAN FALK AND
HILARY P. GARDNER AND JUDITH C. GARDNER,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A8) is reported at 954 F.2d 836. The opinion of the Tax Court (Pet. App. A26-A42) is unofficially reported under the caption *Fox* v. *Commissioner*, 56 T.C.M. (CCH) 863. The supplemental opinion of the Tax Court is unofficially reported under the caption *Kazi* v. *Commissioner*, 61 T.C.M. (CCH) 1759 (1991).

JURISDICTION

The judgment of the court of appeals was entered on January 22, 1992. The petition for a writ of certiorari was filed on February 21, 1992. The juris-

diction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. From 1975 through 1977, petitioners Charles H. Falk and Hilary P. Gardner participated in commodities tax straddle transactions on the London Metal Exchange.[1] Petitioners stipulated that their transactions were of the same type as the London option straddle transactions that were held to be shams, devoid of economic substance, in *Glass* v. *Commissioner*, 87 T.C. 1087 (1986) (Pet. App. A4).[2] Petitioners' transactions were designed to yield putative "ordinary loss[es]" in the first year, which could be deducted against unrelated ordinary income, and approximately equal offsetting "long-term capital gain[s]" in the second year (Pet. App. A30-A33). Because these transactions lacked economic substance, the Commissioner disallowed the deductions resulting from the claimed "losses" and determined deficiencies in Mr. Falk's 1975-1978 tax years and in Mr. Gardner's 1975-1977 tax years (*id.* at A26-A28).

---

[1] Mrs. Falk and Mrs. Gardner are petitioners by virtue of their filing joint returns with their husbands (Pet. App. A29).

[2] *Glass* v. *Commissioner* is the caption of some 1400 consolidated cases. Appeals from *Glass* have now been heard by nine courts of appeals, each of which has affirmed the Tax Court decision. See *Dewees* v. *Commissioner*, 870 F.2d 21 (1st Cir. 1989); *Friedman* v. *Commissioner*, 869 F.2d 785 (4th Cir. 1989); *Killingsworth* v. *Commissioner*, 864 F.2d 1214 (5th Cir. 1989); *Ratliff* v. *Commissioner*, 865 F.2d 97 (6th Cir. 1989); *Yosha* v. *Commissioner*, 861 F.2d 494 (7th Cir. 1988); *Kielmar* v. *Commissioner*, 884 F.2d 959 (7th Cir. 1983); *Lee* v. *Commissioner*, 897 F.2d 915 (8th Cir. 1989); *Keane* v. *Commissioner*, 865 F.2d 1088 (9th Cir. 1989); *Bohrer* v. *Commissioner*, 945 F.2d 344 (10th Cir. 1991); and *Kirchman* v. *Commissioner*, 862 F.2d 1486 (11th Cir. 1989).

Petitioners contended that, as commodities dealers, they were entitled to deduct the putative losses under Section 108 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 630-631, as amended by Section 1808(d) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2817-2818 (Section 108), even though the transactions lacked economic substance. As amended, Section 108(a) provides that losses attributable to the disposition of one leg of a commodity straddle are deductible if incurred in a "trade or business" or in a "transaction entered into for profit." Section 108(b), as amended, provides that a "loss incurred by a commodities dealer * * * shall be treated as a loss incurred in a trade or business" (Pet. App. A83 n.7). Relying on Section 108, petitioners and others similarly situated sought a redetermination of the deficiency asserted against them for their straddle transactions. The Tax Court rejected this contention, holding that Section 108(b) does not allow putative losses incurred in prearranged transactions that lack economic substance to be deducted (Pet. App. A33-A40). The Third Circuit affirmed the Tax Court decision (939 F.2d 44 (1991)), and this Court denied certiorari (112 S. Ct. 590 (1991)).

2. To implement the Tax Court's rulings, the Commissioner filed proposed computations of deficiencies pursuant to Tax Court Rule 155. Petitioners objected to the computation of their deficiencies for 1975, contending for the first time that, under the doctrines of equitable recoupment and equitable estoppel, the deficiencies attributable to the disallowed straddle "losses" in 1975 should be offset by the taxes petitioners allegedly paid on straddle "gains" reported in 1979. Petitioners sought to rely upon these equita-

ble theories because a suit for refund of the 1979 taxes was then barred by the statute of limitations.

On January 30, 1991, the Tax Court rejected petitioners' proposed computation of their 1975 deficiencies in a decision entered under the caption of *Kazi* v. *Commissioner*, 61 T.C.M. (CCH) 1759 (1991). The court noted that "[i]t is well established that as a court of limited jurisdiction we cannot expand our jurisdiction by granting equitable relief" (Pet. App. A21). The court declined to reduce the 1975 deficiencies by the amount of taxes petitioners allegedly paid on corresponding fictitious straddle gains reported in 1979, a year barred by the statute of limitations, holding that the Tax Court "does not have equitable recoupment jurisdiction" (Pet. App. A22).

3. On appeal, the Second Circuit found the taxpayers' arguments to be "without merit" and affirmed (Pet. App. A1-A8). The same Tax Court decision was appealed by another party to the Third Circuit, which affirmed the Tax Court decision by judgment order. *Massy* v. *Commissioner*, 950 F.2d 723 (3d Cir. 1991).[3]

ARGUMENT

The court of appeals correctly concluded that the Tax Court lacks jurisdiction to apply the doctrine of equitable recoupment and that the Commissioner is not equitably estopped from asserting the deficiencies in this case. The decision of the court of appeals does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

---

[3] A petition for a writ of certiorari from that decision (*Lerman* v. *Commissioner*, No. 91-1369) is currently pending before the Court.

1. The doctrine of equitable recoupment allows a court of proper jurisdiction to permit a party "litigating a tax claim in a timely proceeding * * * [to] seek recoupment of a related, and inconsistent, but time-barred claim relating to the same transaction." *United States* v. *Dalm*, 494 U.S. 596, 608 (1990). Since this Court's decision in *Commissioner* v. *Gooch Milling & Elevator Co.*, 320 U.S. 418 (1943), however, it has been established that the jurisdiction of the Tax Court is strictly limited by statute, that that court has no authority to enlarge upon that stautory grant of jurisdiction, and that the Tax Court has no jurisdiction to apply the doctrine of equitable recoupment. *Id.* at 420-422. See, *e.g.*, *Commissioner* v. *McCoy*, 484 U.S. 3, 6-7 (1987) (per curiam); *Knapp* v. *Commissioner*, 867 F.2d 749, 754 (2d Cir. 1989); *Phillips Petroleum Co.* v. *Commissioner*, 92 T.C. 885, 888 (1989).

In *Gooch Milling*, the taxpayer had overpaid its taxes for its 1935 fiscal year because it had made an erroneous valuation of its inventory that year. On the basis of the corrected inventory valuation the following year, the Commissioner asserted a deficiency against the taxpayer for its 1936 fiscal year taxes. The taxpayer filed a petition for redetermination of the deficiency asserted against it for 1936 with the Board of Tax Appeals (the predecessor of the Tax Court) and sought to offset the 1935 overpayment against the 1936 deficiency. At that time, Section 272(g) of the Internal Revenue Code of 1939 (26 U.S.C. (1952)) (the predecessor of Section 6214(b) of the current Code) provided that, while the Board could consider facts relating to other years when redetermining a deficiency, the Board had "no jurisdiction to determine whether or not the tax for any other taxable year has been overpaid or underpaid."

Interpreting that provision, this Court held that the Board lacked jurisdiction to apply the doctrine of equitable recoupment (320 U.S. at 420). The Court noted (*id.* at 420-421):

> The redetermination of the tax liability for the 1936 fiscal year was in no way dependent on any prior tax assessment or overpayment. Likewise, neither the fact that the prior overpayment could no longer be refunded nor the fact that the overpayment exceeded the amount of the deficiency had any relevance whatever to the redetermination of the correct tax for the 1936 fiscal year.

The Court concluded that equitable recoupment is not available in proceedings before the Board because (*id.* at 422):

> The Internal Revenue Code, not general equitable principles, is the mainspring of the Board's jurisdiction. Until Congress deems it advisable to allow the Board to determine the overpayment or underpayment in any taxable year other than the one for which a deficiency has been assessed, the Board must remain impotent when the plea of equitable recoupment is based upon an overpayment or underpayment in such other year.

Following *Gooch Milling*, courts have consistently held that the Tax Court lacks jurisdiction to apply equitable recoupment. In *Rothensies* v. *Electric Storage Battery, Co.*, 329 U.S. 296 (1946), this Court, citing *Gooch Milling*, stated that "the Tax Court has no jurisdiction to consider recoupment" and that, therefore, "the availability of [that] remedy would depend on diverting the litigation to the district courts." *Id.* at 303. Accord, *Continental Equities, Inc.* v. *Commissioner*, 551 F.2d 74, 82-84 (5th Cir. 1977); *Estate of Schneider* v. *Commissioner*, 93 T.C. 568, 570 (1989); *Phillips Petroleum Co.*, 92 T.C. at

889-890. The decision of the court of appeals in the present case is consistent with this uniform line of authority.

Petitioners err in contending (Pet. 12-18) that *United States* v. *Dalm*, *supra*, casts doubt on this long line of authority. While the Court observed in *Dalm* that it did not need to reach the question whether the taxpayer could have raised a recoupment claim in the Tax Court in that case (494 U.S. at 611 n.8), the Court did not intimate that it disagreed with the well-settled state of the law on this issue. Instead, the Court observed (494 U.S. at 610 (emphasis added)):

> Our holding today does not leave taxpayers in Dalm's position powerless to invoke the doctrine of equitable recoupment. Both the Secretary, at the administrative level, * * * *and a court which has jurisdiction over a timely suit for refund* may consider an equitable recoupment claim for an earlier tax paid under an inconsistent theory on the same transaction.

Equitable recoupment has been allowed by this Court only in courts whose jurisdiction is not restricted in the manner of the Tax Court. See *Bull* v. *United States*, 295 U.S. 247 (1935) (suit brought in the Court of Claims); *Stone* v. *White*, 301 U.S. 532 (1938) (suit brought in federal district court).

Petitioners' reliance (Pet. 17-18) on Justice Stevens' dissent in *Dalm* is equally unavailing. Justice Stevens stated that the holding in *Gooch Milling* that equitable recoupment was not available in the Tax Court was limited to the situation that existed in that case, where the recoupment claim was based on an overpayment of taxes in a year *other than the year in dispute* in the Tax court proceeding. 494 U.S. at 61 n.3. Justice Stevens pointed out, by con-

trast, that the taxpayer in *Dalm* sought recoupment with respect to overpayments made *during the same tax year* as the year in dispute. *Ibid.* The present case, however, involves alleged overpayments arising in a different year than the year of the deficiencies, as was the case in *Gooch Milling*, not an overpayment arising in the same tax year, as in *Dalm*. Thus, the distinction between *Dalm* and *Gooch Milling* that Justice Stevens draws in his dissent in *Dalm* is not applicable to the present case.

Nor is there merit in petitioners' further argument (Pet. 18 n.10, 42-43) that the Tax Court has jurisdiction under Section 6214(b) of the Internal Revenue Code—the successor to the provision this Court construed in *Gooch Milling*—to offset the taxes allegedly paid on the sham straddle gains in a year not before the Tax Court against the deficiency determined for a year that is before the court. To be sure, as petitioners contend (Pet. 43), Section 6214(b) allows the Tax Court to "consider such facts with relation to the taxes for other years * * * as may be necessary correctly to redetermine the amount of such deficiency." 26 U.S.C. 6214(b). An example of such a situtation is where the court must determine the proper computation of a net operating loss carryover. See, *e.g.*, *Lone Manor Farms, Inc.* v. *Commissioner*, 61 T.C. 436 (1974), aff'd in an unpublished opinion, 510 F.2d 970 (3d Cir. 1975). Net operating loss carryovers obviously require the court to examine the facts relating to the year in which the loss arose or was claimed, which may not be a year before the court, as a preliminary step in determining the correct amount of a net operating loss carryover to the taxable year in issue.

By contrast, no fact pertaining to petitioners' 1979 year, which was not before the court, is "necessary"

for determination of the deficiencies in petitioners' 1975 tax liabilities. The 1975 deficiencies were determined simply by disallowing the sham straddle losses that petitioners deducted on their 1975 returns. It is not necessary to know the amount of gain improperly included in income in 1979 to determine the amount of loss improperly claimed in 1975. In attempting to blur the distinction between the two separate years, petitioners ignore the well-settled principle that our tax system operates on an annual accounting basis and not on a transactional basis. See *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 365-366 (1931); *Hillsboro Nat'l Bank* v. *Commissioner*, 460 U.S. 370, 377-380 & n.10 (1983); *Landreth* v. *Commissioner*, 859 F.2d 643, 649 (9th Cir. 1988). Thus, as in *Gooch Milling*, petitioners seek to offset an alleged overpayment from a year not before the Tax Court against a deficiency determined in a year properly before that court. Just as the petitioner in *Gooch Milling* was barred from doing so by Section 272(g) of the Internal Revenue Code of 1939, so are petitioners here barred from doing so by Section 6214(b) of the current Code.[4]

2. Petitioners contend in the alternative (Pet. 54-60) that the Commissioner should be equitably estopped to deny the sham ordinary loss deductions they claimed in 1975 since petitioners had reported and paid taxes on the sham capital gains in 1979. According to petitioners, "it would be inequitable to

---

[4] We note that taxpayers are not necessarily without recourse when a refund is barred by the statute of limitations. Under appropriate circumstances, taxpayers may seek relief from the bar of the statute of limitations under the mitigation provisions of the Internal Revenue Code, Sections 1311 *et seq.* See *United States* v. *Dalm*, 494 U.S. at 610.

find a deficiency which took no note of such erroneous inclusion of income" (Pet. 56).

The traditional elements of equitable estoppel in an action involving private parties are (1) a misrepresentation by the party against whom estoppel is asserted; (2) reasonable reliance on that misrepresentation; and (3) detriment to the other party. *Heckler* v. *Community Health Services of Crawford County, Inc.*, 467 U.S. 51, 59 (1984). Where, as here, estoppel is sought against the government, a far more stringent standard is applied. At a minimum, there must be affirmative misconduct on the part of government agents that significantly imperils the "interest of citizens in some minimum standard of decency, honor, and reliability in their dealings with their Government." *Id.* at 61. Although this Court has not flatly ruled out the possibility of estoppel against the government under any circumstances, it has yet to decide a case sustaining estoppel against the government. *E.g.*, *Heckler* v. *Community Health Services*, 467 U.S. at 60; *OPM* v. *Richmond*, 110 S. Ct. 2465 (1990); *Federal Crop. Ins. Corp.* v. *Merrill*, 332 U.S. 380, 383 (1947).

There is, in any event, no basis for invocation of equitable estoppel against the Commissioner in the instant case. There has been no misrepresentation by the Commissioner or his agents, and petitioners have pointed to none. There has been no reliance by petitioners on any such asserted misrepresentation by the Commissioner or his agents. Petitioners cannot, and do not, claim to have detrimentally relied on any representation by the Commissioner or his agents. Finally, petitioners allege no "affirmative misconduct" by the Commissioner or his agents that would amount to a fraud on the taxpayers' rights. To the

contrary, the Commissioner consistently has maintained that petitioners' straddle transaction losses *and* gains were shams, and he placed petitioners on notice of that position in the statutory notice of deficiency. There is thus no basis for a claim of estoppel in this case, and certainly not for a claim of estoppel against the government.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

JAMES A. BRUTON
Acting Assistant Attorney General

KENNETH L. GREENE
KIMBERLY S. STANLEY
Attorneys

APRIL 1992

☆ U. S. GOVERNMENT PRINTING OFFICE: 1992 312324 45392